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STATE OF MONTANA

INVESTMENT DIVISION
AND
INVESTMENT COMMISSIONER

Report on the Need for State Regulation
of the Securities Industry

1978

A SUNSET PERFORMANCE REVIEW



77-SS-12

Office of the Legislative Auditor



STATE OF MONTANA

Office of the Legislative Auditor

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The Legislative Audit Committee
of the Montana State Legislature:

Herein transmitted is our sunset performance audit of the Montana Investment Division and Investment Commissioner. The audit was conducted in response to the 1977 sunset law, which terminates the division on July 1, 1979. The intent of the audit was to determine the need for state regulation of Montana's securities industry.

The audit focused upon the six questions of the sunset law and includes an examination of division operations. It does not encompass a review of the division's financial transactions or overall compliance with state laws.

There are no formal recommendations in the report since the responsibility for such recommendations lies with the Legislative Audit Committee. Nevertheless, we discussed the contents of the report with the Investment Commissioner, Deputy Commissioner, and other members of the Investment Division staff.

We wish to express our appreciation to the Investment Commissioner and the Investment Division staff for the assistance they provided during the audit. We also wish to thank members of the securities industry throughout the state for the assistance they gave us.

Respectfully submitted,

Morris L. Brusett
Morris L. Brusett, C.P.A.
Legislative Auditor



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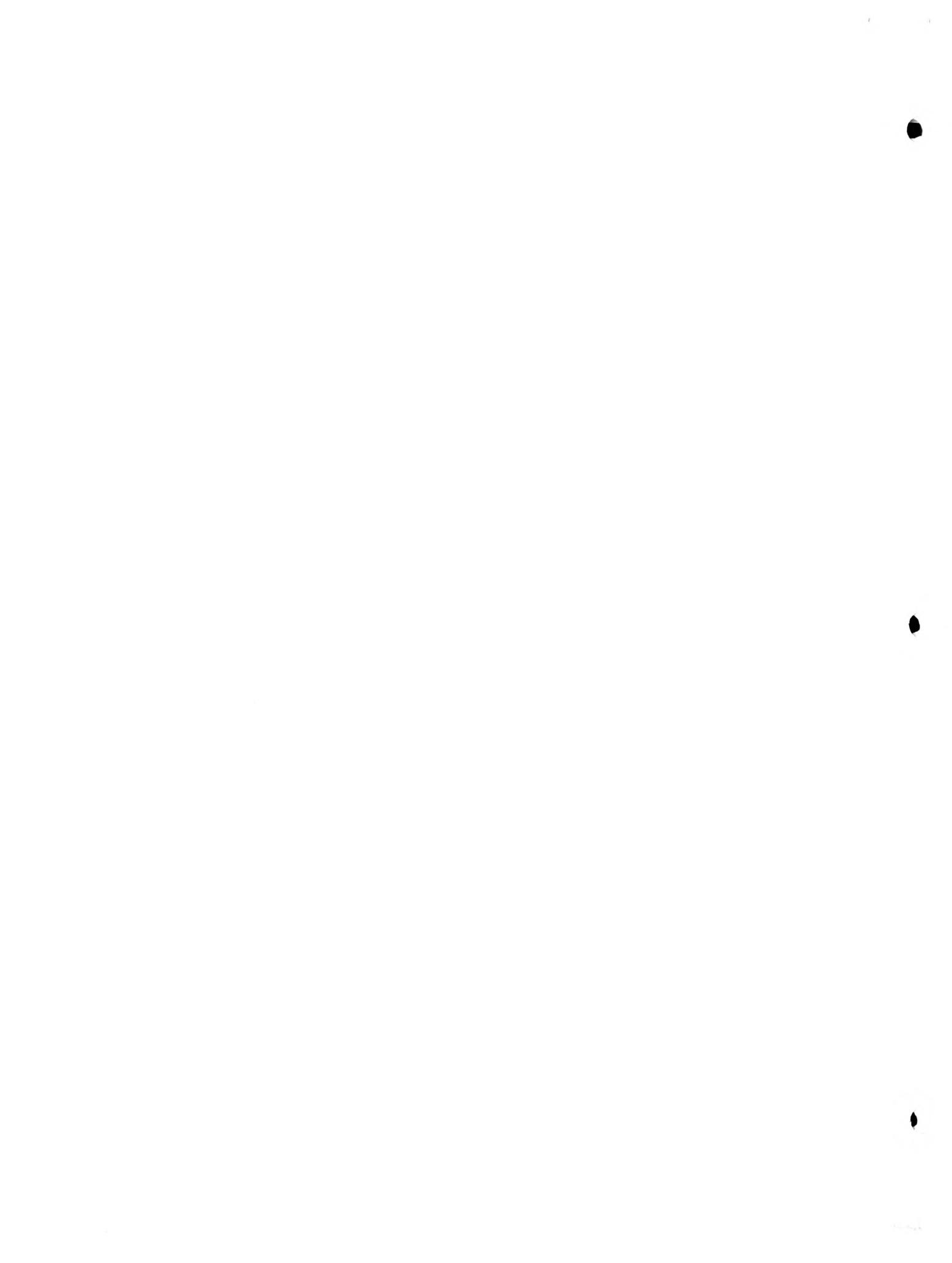
ADMINISTRATIVE OFFICIALS

STATE AUDITOR'S OFFICE

INVESTMENT DIVISION

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OFFICE OF THE LEGISLATIVE AUDITOR

SUNSET PERFORMANCE AUDIT OF THE
OFFICE OF INVESTMENT COMMISSIONER
AND THE INVESTMENT DIVISION

SUMMARY

Montana's 1977 Legislature passed Senate Bill 162 and Chapter 562, Laws of Montana, 1977. The law, commonly referred to as the "sunset law," terminates numerous regulatory boards and agencies and specifically calls for a performance audit of each agency prior to scheduled termination. The sunset law terminates the Investment Division on July 1, 1979. This performance audit is in response to the legal requirement for review of the agency prior to termination.

Chapter I (page 1) introduces the report by explaining the objectives and intent of sunset legislation, the six questions which relate to the need for state regulation and activities of the state directed toward meeting that need, and the scope of our audit.

Chapter II (page 5) provides a background on the evolution of securities industry regulation by tracing its beginnings in Montana and in the United States. The chapter then examines the nature of securities transactions nationwide (page 8) and profiles Montana securities (page 13). This chapter also presents the Investment Division's organization and funding (page 16). Lastly, the department operations (page 17) are described. The operations include registration of securities, broker-dealers, salesmen and

investigative adviser. The division also investigates and examines registrations and possible fraudulent practices.

Chapter III (page 33) addresses the need for regulating the securities industry in Montana and the harm which could result from deregulation. Two questions are answered--(1) Would the absence of regulation significantly harm or endanger the public's health, safety, or welfare; and (2) Is there a reasonable relationship between the exercise of the state's police power and the protection of the public's health, safety, and welfare?

In answer to the first question (page 53), we conclude that through examination of all forms of regulation evidence is provided to say that the absence of state regulation in the securities industry could significantly endanger the public's health, safety, and welfare.

The second question relates to whether the current activities are sufficient to protect the public from potential harm addressed in the first question. To answer this question we evaluated the division's current regulation of the securities industry in Montana (page 57). The evaluation of the functions of the division disclosed that in each case there was a reasonable relationship to the protection of the public (page 57).

Chapter IV (page 66) addresses a single question--Are all facets of the regulatory process designed solely for the purpose of and have as their primary effect, the protection of the public? This chapter considers the possibility that

some areas of present regulation to be inadequate to sufficiently protect the public. Departmental staffing is considered (page 66) and the need for a more formal training program is stated. A review of the payment of registration examination expenses discloses a need for clarification of the related statutes (page 68). The nature of investigation files (page 69) is also discussed, and the bonding requirement (page 70) and mutual fund sales (page 72) are presented as being in need of division review. The chapter concludes that certain facets of the regulatory process could be improved thus furthering the protection of the public.

Chapter V (page 74) considers two questions--Does the regulation have the effect of directly or indirectly increasing the cost of goods or services; and, Is the increase in cost more harmful to the public than the harm which could result from the absence of regulation? The costs of securities regulation definitely add to the costs of securities and these costs must be eventually paid by the consumer (page 75). From a historical perspective, the absence of regulation could generate social and economic costs far in excess of the present costs of regulation (page 76).

Chapter VI (page 77) addresses the sixth and final question--Is there another less restrictive method of regulation available which could adequately protect the public? The report discusses the present form of regulation used in Montana and other less restrictive alternatives which are available, including no regulation. Included are three

tables designed to aid the Legislative Audit Committee in recommending the regulatory alternative most appropriate for Montana, and alternative regulatory facets under each form of regulation. Additionally, a supplement to all sunset reviews has been prepared for a more indepth discussion of the regulatory alternatives in Chapter VI.

Chapter I

INTRODUCTION

This sunset performance audit addresses the need for state regulation of the securities industry by the investment commissioner and the Investment Division,¹ State Auditor's Office. The investment commissioner and the Investment Division (hereinafter referred to as the division) have the responsibility of protecting the securities buying public of Montana.

REPORT OBJECTIVES

The 1977 Legislature passed a law terminating numerous regulatory boards and agencies, including the position of investment commissioner and the Investment Division.² This law, commonly referred to as the "sunset law," requires the Legislative Audit Committee to conduct a performance audit of each terminated agency. The performance audit must review the need for each department/agency and the Legislative Audit Committee must offer recommendations for re-establishment, modification, or termination of the department/agency in question.

¹ The Investment Division was created as a regulatory unit of the State Auditor's Office. The organizational structure of the State Auditor's Office was not subject to the 1971 Executive Reorganization standard terminology. The Investment Division is known as a "division" although it is not created pursuant to the 1971 Reorganization Act.

² Title 82, Chapter 46, R.C.M. 1947.

In defining legislative intent, the sunset law states that, by requiring periodic evaluation in the form of a performance audit, the legislature will be in a better position to ensure that agencies and programs exist only to be responsive to state citizens' needs. The sunset law terminates the division on July 1, 1979. This sunset performance audit is in response to the legal requirement for review prior to the division's termination.

REPORT ORGANIZATION

The sunset law requires the thorough examination of the following questions during the conduct of the performance audit:

"(a) Would the absence of regulation significantly harm or endanger the public health, safety, or welfare?

(b) Is there a reasonable relationship between the exercise of the state's police power and the protection of the public health, safety, or welfare?

(c) Is there another less restrictive method of regulation available which could adequately protect the public?

(d) Does the regulation have the effect of directly or indirectly increasing the costs of any goods or services involved and, if so, to what degree?

(e) Is the increase in cost more harmful to the public than the harm which could result from the absence of regulation?

(f) Are all facets of the regulatory process designed solely for the purpose of, and have as their¹ primary effect, the protection of the public?"

Chapter I is introductory. It summarizes the objectives, organization, and scope of this report.

¹ Senate Bill 162, enrolled as Chapter 562, Laws of Montana, 1977, and codified as Title 82, Chapter 46, R.C.M. 1947.

Chapter II presents background information on the evolution of the securities industry. Included in this background information is a discussion of the significance of securities and investments in the United States and in Montana. Chapter II concludes with a discussion of the division's organization, staffing, funding, specific goals and functions. Chapter III addresses two of the questions posed in the sunset law. The first question asks if the absence of regulation would significantly harm or endanger the public's health, safety, or welfare. To answer this question we analyze the extent to which the public depends upon the current regulation of the securities industry and its product.

The second question addressed in Chapter III asks if there is a reasonable relationship between the exercise of the state's police power and the protection of the public's health, safety, or welfare. To analyze and address this question, we review Montana's securities regulation law and discuss the current performance of the division.

Chapter IV addresses another question posed by the sunset law: Whether all facets of the regulatory process have as their sole purpose the public's protection. To respond to this question we review the current operations of the division in relation to the various laws, rules, and regulations.

Chapter V addresses two additional questions of the sunset law. That is, whether state regulation of the

securities industry has the effect of directly or indirectly increasing the costs to the public and whether such an increase is more harmful than the harm which could result from the absence of regulation.

Chapter VI presents alternative methods of regulating the securities industry in Montana.

SCOPE OF THE AUDIT

This performance audit primarily addresses the need for state regulation of the securities industry. It focuses upon the six questions posed in the sunset law and includes an examination into the effectiveness of the operations of the division. It does not encompass a review of the financial transactions of the division or the division's compliance with all state laws.

Chapter II

BACKGROUND

EVOLUTION OF SECURITIES REGULATION

In 1913 the 13th Legislative Assembly of the state of Montana passed a law that created the Office of the Investment Commissioner and gave this office the authority to regulate investment companies and stockbrokers.¹ Included in this authority was the power to license the sale of securities by companies and stockbrokers. The law also provided for the regulation of the promotion, organization, and operation of investment companies and the business of stockbrokers.

The Montana securities law, as originally adopted, was similar to most other state laws regulating the sale of securities at that time. Montana's law was a "qualification" type statute. It vested with the investment commissioner the duty and responsibility to determine if an offering of securities was "fair, just, and equitable."

In 1956 the "Uniform Securities Act" was drafted by the Conference of Commissioners on Uniform State Laws and the American Bar Association. The act resulted from a two-year study of states' securities regulation conducted by the American Bar Association, the North American Securities Administrators Association, the Securities and Exchange Commission (SEC), the Investment Bankers Association of

¹ Chapter 85, Laws of Montana, 1913.

America, and the National Association of Securities Dealers (NASD).

The Uniform Act reflected the basic principles of state securities laws which are often called "blue sky" laws. The act included a prohibition against fraudulent practices; required the registration of brokers, dealers, investment advisers, and securities. The act also contained general provisions for judicial review, investigation, and injunctive and criminal proceedings. The act was drafted in such a manner that various parts of the law could be accepted by the states without incorporating the entire act.

At the time Montana was contemplating new securities legislation, the Uniform Securities Act had been adopted by several other states. In 1961, the Montana Legislature adopted the Uniform Act (with a few variations). The new law became effective on July 1, 1961, and was titled the Securities Act of Montana.¹ The act remains in effect today and attempts to improve the all-inclusive "fair, just, and equitable" test by providing definite criteria to be applied by the investment commissioner in ruling on the merits of a proposed offering.

The Montana securities law did not become "fully operative" until March 30, 1964, when the State Auditor adopted rules and regulations as is his authority under the act.

¹ Section 15-2001 et seq., R.C.M. 1947.

(The State Auditor is the ex officio investment commissioner.) Since its passage in 1961, the act has been amended slightly. Phraseology, word additions and deletions, and style changes account for most of the amendments.

Regulation of certain aspects of the sale of securities also occurs at the federal level. Federal regulation began in the 1930s. The Securities and Exchange Commission (SEC) was created in 1934 to administer federal securities laws. These laws include the Securities Act of 1933,¹ the Securities Exchange Act of 1934,² the Public Utility Holding Act of 1935,³ the Trust Indenture Act of 1939,⁴ the Investment Adviser Act of 1940,⁵ and the Investment Company Act of 1940.⁶

The purpose of registration and regulation at the federal level is to provide the investor with adequate disclosure of facts related to a security and the company offering the security. The SEC cannot deny registration of a security based on factors such as price, or terms, or the fact that the security reflects an investment of substantial risk. The federal acts are "disclosure" type securities laws. The SEC has no authority to evaluate the merits of a

¹ 15 USCS, (Section 77a et seq).

² 15 USCS, (Section 78a-78jj).

³ 15 USCS, (Section 79-79z-6).

⁴ 15 USCS, (Section 77aaa-77bbbb).

⁵ 15 USCS, (Section 80b-1-80b-21).

⁶ 11 USCS, (Section 72(a), 107(f); 15 USCS; 80a-1-80a-52).

proposed offering. The SEC requires brokers and dealers engaged in the interstate securities business to register, and these brokers and dealers must conform to the standards and regulations prescribed by law.

In addition to the various securities laws, the United States Congress, in 1938, provided for self-policing bodies for brokers and dealers engaged in transactions in securities which are not listed on any of the national stock exchanges. Only one association, the National Association of Securities Dealers, Inc. (NASD), is registered with the SEC under this provision.

In 1970 the United States Congress passed the Securities Investor Protection Act.¹ The act's primary purpose is to afford protection to public customers in the event broker-dealers encounter financial difficulties and are unable to satisfy financial obligations. The law also created the Securities Investor Protection Corporation (SIPC) to administer the act.

OVERVIEW OF SECURITIES TRANSACTIONS

As discussed in Montana laws and federal securities laws, a security is any note, stock, treasury stock, or bond. The definition of a security includes debentures and certificates of interest or participation in any profit-sharing agreement. Evidence of indebtedness, certificates of collateral-trust, certificates of preorganization and voting trust, certificates of deposit

¹ 15 USCS, (Section 78aaa-78lll).

for a security, and certificates of interest or participation in oil, gas, or mining titles or leases are considered to be securities. Investment contracts, transferable shares, and payments out of production under oil, gas, or mining titles or leases are also securities. In general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, receipt for, guarantee of, or right to subscribe or purchase any of the above mentioned is a security.

Securities the general public buys and sells most often fall into two general classifications--stocks and bonds. When stocks are purchased, an individual buys the right to share in the ownership of an entity. However, if no profits are earned by the entity, the individual must forego the right to earnings just like the owner of any type of business. Bonds, on the other hand, place the individual in the position of a creditor. He is entitled to collect interest each year, even if the entity issuing the bond does not earn a profit.

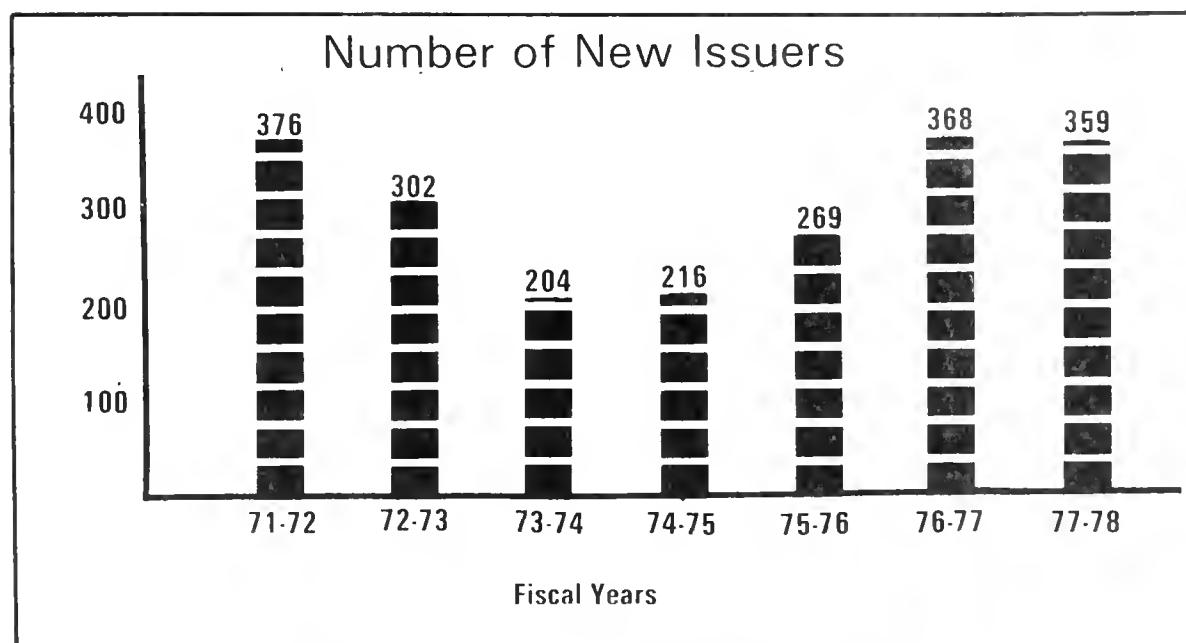
Stock purchasing is widespread. Over 33 million persons held publicly owned issues of common and preferred stock in American corporations in 1975, compared to 8.6 million in 1956.¹ These shareholders were equally divided between men and women. Sixty-six percent of them were 45 years of age and over. Eighty-six percent of the 33 million

¹ World Almanac and Book of Facts, 1976.

had at least four years of high school. The largest number of investors came from the \$15,000-\$25,000 income bracket; however, 7,158,000 had incomes over \$25,000.¹ Thus, the "average public investor" is generally between the ages of 45 and 54, has had one to three years of college, and has an income between \$15,000 and \$25,000 per year.

In 1975 the value of new securities offered for sale in the United States in amounts over \$100,000 and registered with the SEC totaled approximately \$52.6 billion (includes stocks, bonds, etc.). There were also many securities sold that did not have to be registered with the SEC and these are not included in the \$52.6 billion.

In Montana alone, the number of new issuers of securities that registered with the Montana Investment Commissioner in the past seven fiscal years is 2,094. (See Illustration 2-1.)



Source: Compiled by Office of the Legislative Auditor.

Illustration 2-1

¹ Statistical Abstract of the United States, 1976.

The cash value of these new securities totaled \$1,383,061,208. The cumulative value of all registered securities for sale in Montana over the last seven years is approximately \$4.5 billion. (See Illustration 2-2.) These totals do not include securities sold which are exempt from registration under Montana law.

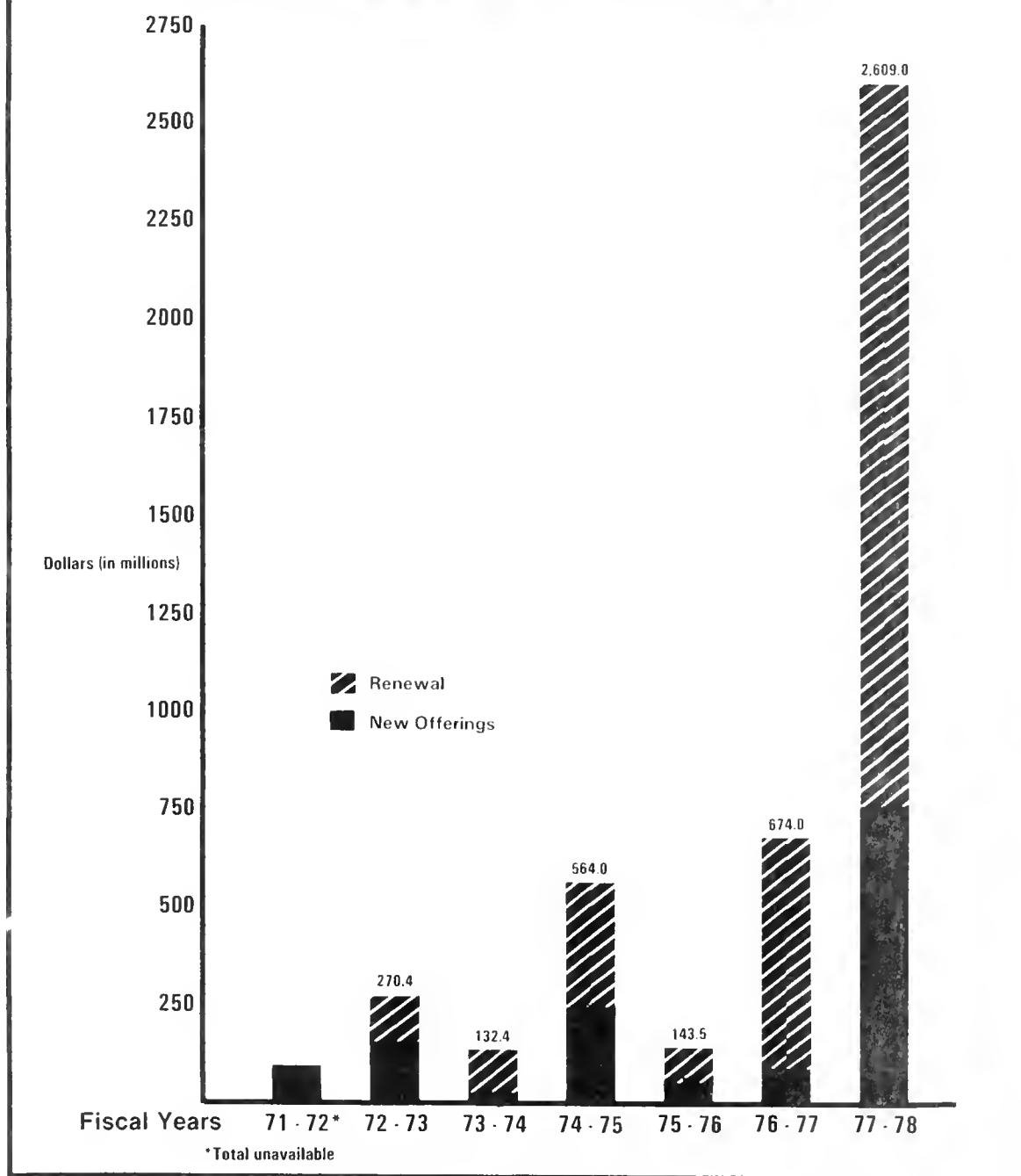
There are several methods used by the Montana investor to buy and sell all types of securities:

- Stock Exchanges.
- Over-the-Counter Market.
- Buying from the issuer.
- Buying from the individual holder.

Stock exchanges provide meeting places where exchange members buy and sell securities for their customers. The over-the-counter market constitutes a market for the securities of thousands of corporations not listed on exchanges. Trading securities in the over-the-counter market occurs in even larger dollar volume than does trading through the organized exchanges. It provides facilities for the initial distribution of new issues and for the liquidation of unusually large amounts of securities that must be sold quickly by large individual holders.

In many cases, where there are a small number of investors buying a single type of security located in a relatively small geographical area, the purchases are done through the salesmen employed by the issuer. In addition, one can also purchase securities directly from the individual shareholder.

DOLLAR AMOUNT OF OFFERINGS



Source: Compiled by the Office of the Legislative Auditor.

Illustration 2 2

PROFILE OF MONTANA SECURITIES

The investment commissioner, under the Securities Act of Montana, regulates issuers, broker-dealers, investment advisers, and salesmen.

The term "issuer" means the entity or entities performing the acts, and assuming the duties of depositor or manager, according to the provisions of an agreement under which a security is issued.

A "broker-dealer" is any entity engaged in the business of effecting transactions in securities for the accounts of others or for its own account. The term "broker," by itself, is defined in the Uniform Commercial Code of Montana. It refers to a person who acts for, buys a security from, or sells a security to a customer.¹ The broker executes buy and sell orders for stocks and bonds. In return for providing this service, the broker receives a commission based on a percentage of the value of the securities bought or sold.

A "salesman," as defined in the Montana Securities Act, is an individual, other than a broker-dealer, who represents a broker-dealer or issuer. The salesman's role is to sell securities.

Any entity which advises others either directly or through publications or correspondence as to the value of

¹ Section 87A-8-303, R.C.M. 1947.

securities is an "investment adviser" (if such services are performed for a commission). An investment adviser also advises others as to the desirability of investing in, purchasing, or selling securities and the adviser may issue analyses or reports concerning securities. A broker-dealer can perform the duties of an investment adviser, but the reverse is not true.

As of June 1978, the following number of broker-dealers, investment advisers, and securities salesmen were licensed to do business in Montana:

Broker-Dealers	131
Investment Advisers	12
Salesmen	1,367

All of these individuals or entities are involved in the business of buying or selling securities offered by issuers in the state of Montana. The division reported that the number of issuers who registered securities in Montana numbered 719 during fiscal year 1977-78. These 719 issuers offered \$2,609,202,331 in securities for sale during this period. This figure does not include securities which are exempt from registration under the Montana Securities Act. For example, any security listed or approved for listing on the New York Stock Exchange, the American Stock Exchange, the Midwest Stock Exchange, or the Pacific Stock Exchange is exempt from registration.

Of 710 issuers registered during fiscal year 1976-77, 23 were domestic issuers--Montana issuers selling Montana

securities to Montana residents. The amount of securities offered by these 23 issuers totaled \$5,278,537 or approximately 8/10 of 1 percent of the total registered offerings made in Montana during that period.

ALL STATES REGULATE

Every state has some form of "blue sky" law. Generally, these laws require registration of securities by some state agency prior to sale. Only New York and Connecticut do not require registration. The general registration requirements in the remaining 48 states vary. Thirty-two states, including Montana, have adopted some version of the Uniform Securities Act, referred to earlier in the chapter. However, all state laws typically employ one or more of three regulatory mechanisms:

- Provisions defining and prohibiting fraud in the offer and sale of securities.
- Provisions regulating and requiring licensing of investment advisers, broker-dealers, and their agents.
- Provisions which require securities registration and which regulate the characteristics of the securities being offered, the offering, and the issuer.

In comparing Montana's method of securities regulation to regulation in other western states (Idaho, North Dakota, Oregon, South Dakota, Utah, Washington, and Wyoming), it was determined that these states also register securities, brokers, and salesmen, and have fraud provisions in their respective acts. Four of the states have a commissioner administering the law. Utah uses a three (3) member investment commission to do the same. Washington's Securities Act

is administered by a Director of Licenses with a seven (7) member advisory committee, while Wyoming administers its law through the Secretary of State.

INVESTMENT DIVISION ORGANIZATION, STAFFING, FUNDING

As of July 1978, the Investment Division was staffed with five persons:

- Chief Deputy Investment Commissioner
- Two Securities Investigator/Examiners
- Two Secretarial Staff

The general duties of the chief deputy are to perform administrative, supervisory, and professional work in the enforcement of the Securities Act of Montana. The chief deputy directs the examination of registrations and the investigations of violations of the Securities Act and makes decisions regarding the referral of matters to other enforcement entities for prosecution or injunctive action.

The investigator/examiners conduct in-office and field examinations and investigations for the purpose of enforcing the provisions of the Securities Act of Montana.

The division is not staffed with a full-time attorney, but has available the services of the staff attorney of the State Auditor's Office. The staff attorney reported that he spent an estimated 30 percent of total available time on securities regulation.

The division's operations are funded through General Fund appropriations. The division collects revenue in the form of registration fees for securities and licensing

(registration) fees for salesmen, broker-dealers, and investment advisers. Revenues also include fees collected for the filing of annual financial statements and renewals. The division's revenues are deposited in the General Fund. Illustration 2-3 details the division's financial history from fiscal year 1971-72 to fiscal year 1977-78.

FINANCIAL HISTORY INVESTMENT DIVISION

Fiscal Year	Revenue	Expenditures
1977-78	\$201,976	\$81,545
1976-77	136,856	71,822
1975-76	115,836	69,142
1974-75	111,410	38,981
1973-74	106,905	40,744
1972-73	120,886	32,878
1971-72	128,306	32,536

Source: Compiled by the Office of the Legislative Auditor

Illustration 2-3

DIVISION'S OBJECTIVES AND OPERATIONS

Division officials reported a number of division goals and objectives. A list of these follows:

- Registration of securities, broker-dealers, investment advisers, and securities salespersons.
- Surveillance of prohibited practices and enforcement through examinations and investigations within and outside the state of Montana.

- Collection of fees under the Securities Act of Montana.
- Continued liaison with other states, Canadian provinces, and the Securities and Exchange Commission for registrations, enforcement, and surveillance of securities offerings.
- Promotion of legislation, and promulgation of rules and forms to adjust to the changing needs and protection of the investing public.

Brief discussions of each of these areas of division operations appear below.

Registration of Securities

The investment division registers securities in three different manners: (1) Coordination, (2) Qualification, and (3) Notification.

COORDINATION--Registration by coordination provides a method of state registration of federally registered securities. Coordination relies on the fact that all relevant information concerning the security is contained in the prospectus (printed statement that describes an enterprise) filed with the SEC. Paperwork is minimized by using the federally required prospectus as the basic source of information. The investment commissioner, however, requires further information:

- The amount of securities to be offered in the state.
- Other states where registration is expected.
- Report of any adverse judgments against offering.
- Appointment of attorney for service of process.
- Articles of incorporations, by-laws, and underwriters agreements.

A random sample of the registered securities on file with the division during fiscal year 1976-77 revealed that the majority of securities were registered by coordination. Projecting the sample results indicates that approximately 648 of the 710 registered securities (or 91.3 percent) are registered by coordination. A registration by coordination becomes effective at the moment the federal registration statement becomes effective, if it has been on file with the division for at least ten days and has met the merit criteria. A registration is not considered filed for the purpose of coordination until all requested information is received by the division.

QUALIFICATION--Any security may be registered by qualification. Normally the applicants for registration by qualification are those securities that are not federally registered. The division issues a guideline for preparation of a prospectus. A uniform application form used by several states is used in Montana to detail what information is required. As with registration by coordination, qualification registration is intended to disclose all pertinent information on an issue so that the investor can make an informed decision. Information required by the commissioner includes:

- A copy of any prospectus or circular.
- Kind and amount of securities.
- Capitalization and long term debt of issuer.
- Balance sheet of the issuer.

--Any adverse orders or judgments.

--Estimated cash proceeds to be received by issuer.

This type of registration is common among "domestic" issuers--Montana issuers selling to Montanans. We sampled the securities registered in Montana and project that approximately 61 registered securities (8.7 percent) are registered by qualification. A registration statement by qualification becomes effective when the commissioner so orders.

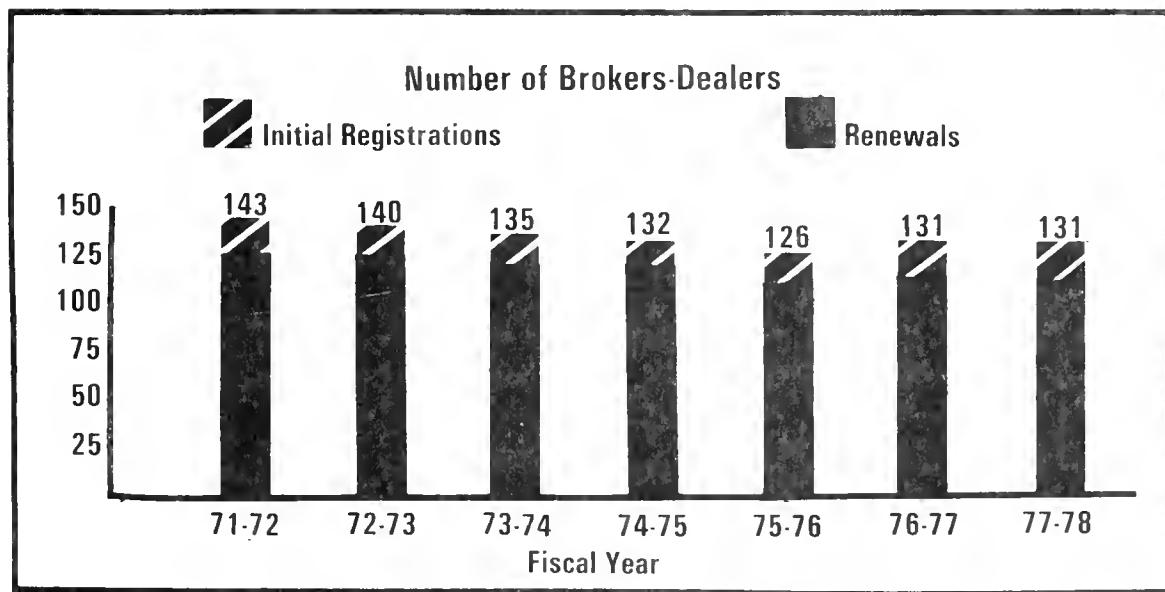
NOTIFICATION--Registration by notification is designed for the registration of securities of companies which have an established earnings record. Notification is intended to afford "quality" securities certain advantages over registration by qualification. The information required in the registration statement is more limited; however, the commissioner's discretionary grounds for withholding registration are the same for quality securities as for all other nonexempt securities. This method of registration is not frequently used and our sample did not reveal one registration by notification. From discussions with division officials, we were able to determine that only a few issues (2 or 3) may be registered in this manner.

Registration of Broker-Dealers

It is unlawful for any person to transact business in the state of Montana as a broker-dealer, unless he is registered (licensed) under the Securities Act of Montana

(except in exempt transactions). The broker-dealer application, by law, must contain whatever information the investment commissioner requires. The application used by the division is a uniform form used by other states and by the Securities and Exchange Commission. A state supplemental information form is also required and this form is uniform in composition with other states.

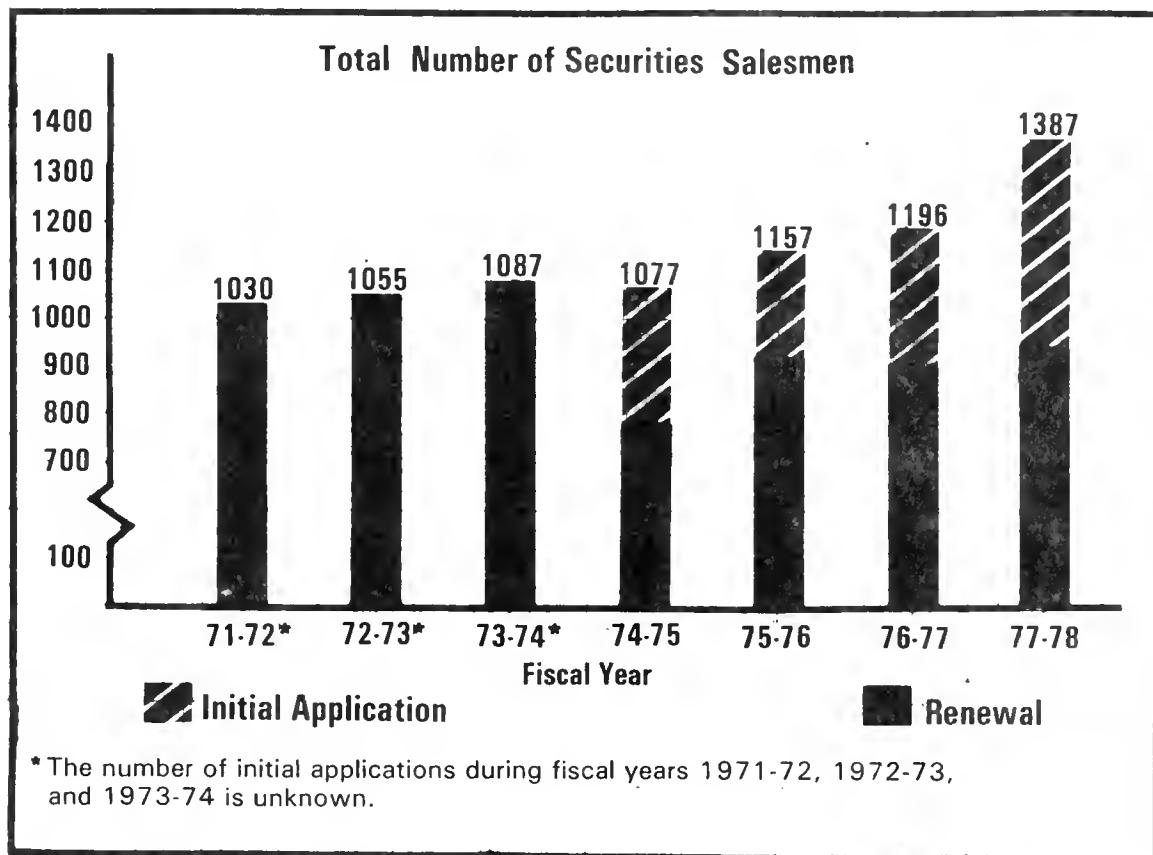
Renewal of broker-dealer registration takes place on March 1 of each year and is accompanied by a \$200 fee. Two hundred dollars is also the original application fee. Illustration 2-4 represents the relatively stable number of broker-dealers registered in Montana over the last seven fiscal years.



Source: Compiled by the Office of the Legislative Auditor
Illustration 2-4

Registration of Salesmen

It is also unlawful for any person to transact business in this state as a securities salesman unless the person is registered. The application for registration is a uniform type used by other states and by the NASD. The registration and renewal fee is \$25. The number of salesmen registered with the Investment Division over the past seven fiscal years is represented in Illustration 2-5.



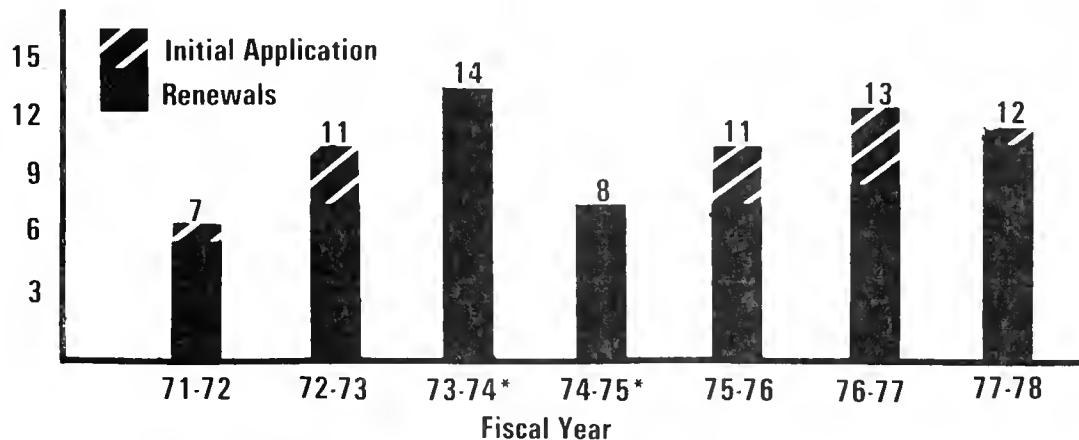
Source: Compiled by the Office of the Legislative Auditor.

Illustration 2-5

Registration of Investment Advisers

It is illegal for any person to transact business in Montana as an investment adviser unless the individual is registered as such, or is registered as a broker-dealer, or his only clients are investment companies or insurance companies. The requirements for application are determined by the investment commissioner. The number of investment advisers in Montana has remained few. (See Illustration 2-6.) The fee for registration and renewal of investment advisers is the same as that of broker-dealers--\$200.

Number of Investment Advisers



*The number of initial applicants for FY 1973-74 and FY 1974-75 is unknown.

Source: Compiled by the Office of the Legislative Auditor

Illustration 2-6

Denials, Revocations, Suspensions, and Withdrawals of Registration

The commissioner may issue an order denying, suspending, or revoking registration. This authority includes the

registration of securities, broker-dealers, investment advisers and salesmen. According to the Securities Act of Montana, such action is to be taken in the public interest and for failure to comply with provisions of the act.

An investigation of the records on file in the Investment Division and conversations with division officials revealed that there has not been a single denial, revocation, or suspension order issued by the commissioner. The policy of the division has been to allow registrations of the type which may require a denial, revocation, or suspension order to withdraw from registration. In this way administrative proceedings were avoided. Withdrawals, however, do not occur solely because of administrative action. Selling all of the securities in other states before the effective date is reached in Montana, failure to complete filing requirements, and termination of business or employment may also bring about withdrawals. Illustration 2-7 details the number of withdrawals since fiscal year 1973-74.

WITHDRAWALS					
Fiscal Year	Total Number	Issuer	Broker-Dealer	I.A.	Salesman
1977-78	40	37	0	2	1
1976-77	46	30	0	1	15
1975-76	61	46	0	0	15
1974-75	63	48	0	0	15
1973-74	90	74	2	0	14

Source: Compiled by the Office of the Legislative Auditor
Illustration 2-7

Because of the authorized destruction of withdrawal files dated prior to June 30, 1976, determination of the reasons for withdrawal could not be determined for fiscal years 1973-74 through 1975-76. A sample of 29 of 86 withdrawal files for 1976-77 and 1977-78 was evaluated. The results of the sample are as follows:

- Thirteen withdrawals after the division questioned material in the registration or previous actions of issuer.
- Four withdrawals because offering sold out in other states.
- Eight withdrawals with no apparent reason on file.
- Two withdrawals because of decision not to sell.
- Two withdrawals for termination of employment.

Exceptions and Exemptions

Exceptions and exemptions to registration of securities or transactions are allowed under the Securities Act of Montana. Exceptions and exemptions are permitted for issuers and individuals who meet certain requirements under the law. It should be noted that in all but one case an exemption can be taken without notifying the division if it is believed the exemption is within the requirements of the law. The commissioner may, by order, deny or revoke the exemption specified in Section 15-2014(2), R.C.M. 1947, with respect to a specific security. Notification to the investment division is an "insurance-type" measure, verifying that it is within the law to take such an exemption.

The number of exemptions filed with the division over the last six years are listed below:

EXEMPTIONS	
Calendar Year	Number
1978	32*
1977	90
1976	96
1975	65
1974	54
1973	102
1972	44

* Through July 1, 1978.

Source: Compiled by the Office of the Legislative Auditor.

Illustration 2-8

The exemption files are destroyed at the end of every calendar year and the name and date for each exemption is recorded. This being the case, the exemption files for 1978 were the only ones available for determination of the type of exemption. A review of all 32 exemption files for 1978 provided the following reasons for exemption:

--Eleven exemptions under Section 15-2014(10) of the act allowing for transactions to existing security holders of the issuer where no commission is paid for soliciting.

--Three exemptions for transactions incident to approved reorganization or merger.

--Two exemptions since securities were registered with exempt stock exchanges.

- Two exemptions granted because issue was guaranteed by the United States.
- Two offers made to a bank or savings institution under Section 15-2014(7) of the Act.
- One withdrew the request for exemption.
- One request for amending previous exemption granted.
- One exemption for a contract issued in connection with employees' benefit plan.
- Four were determined not to be securities or broker-dealers.
- Five exemptions denied due to nonsubmission of fees.

Investigations and Examinations

The commissioner, at his discretion, may make investigations or examinations as deemed necessary to determine whether registration should be granted, denied, or revoked. He may also determine whether any person has violated or is about to violate any provision of the Securities Act or rule or order of the commissioner. The commissioner may, for the purpose of investigation, administer oaths, subpoena witnesses, take evidence, and require production of documents.

The closed investigation files on record with the division included information on 218 cases. Since the types of activities that were investigated vary widely in nature, they cannot be easily categorized. Cases range from fraud investigation to selling nonregistered securities to answering questions from the general public on specific securities.

A summary of the types of enforcement activity that have been performed by the division appears in the tables below.

ENFORCEMENT ACTIVITY

<u>Fiscal Year</u>	<u>Administrative Orders Issued</u>	<u>Cease and Desist Orders</u>	<u>Referral to Other Regulatory Agencies*</u>
1967	0	0	0
1968	0	1	0
1969	0	0	0
1970	0	0	0
1971	0	0	1
1972	0	4	1
1973	3	0	1
1974	2	8	4
1975	1	4	4
1976	1	12	4
1977	0	16	3
1978	<u>0</u>	<u>10</u>	<u>10</u>
TOTAL	7	55	28

*SEC, IRS, NASD, Exchanges, Commodity Futures Trading Commission, other states and other state agencies.

Source: Compiled by the Office of the Legislative Auditor

Illustration 2-9

CRIMINAL CASES			
Fiscal Year	Referred for Prosecution	Defendants Charged	Convictions
1967	0	0	0
1968	4	4	1
1969	0	0	0
1970	0	0	0
1971	1	0	0
1972	0	0	0
1973	0	0	0
1974	5	5	4
1975	5	3	2
1976	4	1	1
1977	8	2	1
1978	<u>10</u>	<u>2</u>	<u>2</u>
TOTAL	37	17	11

Source: Compiled by the Office of the Legislative Auditor
 Illustration 2-10

During this period of time (1967-1978) the division reported being directly involved in returning money to investors due to enforcement action of the commissioner. In an attempt to determine the amounts returned we examined the cases which involved returning of funds. We could verify that during this period the division returned \$806,514 to investors. The division was also involved indirectly with

an out-of-state case that returned an additional \$500,000 to investors in several western states.

Collection of Fees

The fees paid to the commissioner for the first year of registration of securities are:

--\$100 for the first \$100,000 of the offering price.

--Plus 1/20th of 1 percent of the excess over \$100,000.

--The maximum fee is \$1,000.

The payment of a renewal fee each year that a registration remains in effect is computed at 1/20th of 1 percent of the cumulative offering price of the securities during that year. The minimum renewal fee is set at \$100 and the maximum at \$1,000. For registration and renewal of registration of a broker-dealer or investment adviser the fee is \$200. A salesman must pay \$25 for registration and renewal. When any registration application is denied or withdrawn the commissioner retains the fee.

Since fiscal year 1971-72, the investment division has collected \$922,175 in registration fees and annual financial statement fees. (Filing a financial statement requires a \$10 filing fee.) Of this amount, \$367,648 has been expended by the division with \$554,527 remaining in the General Fund.

LIAISON WITH SEC, OTHER STATES, AND CANADIAN PROVINCES

The Securities Act of Montana states that:

". . . In prescribing rules and forms the commissioner may cooperate with the securities administrators of the other states and the securities and exchange commission

. . . to achieve maximum uniformity in the form and content of registration statements, applications, and reports."¹

This is one area where the Investment Division communicates and cooperates with other regulatory agencies. The division uses uniform forms for the registration of securities, broker-dealers, and salesmen. Also, at the time of registration a list of salesmen and broker-dealer applicants is sent to the SEC and NASD. The purpose of the list is to determine if there is any derogatory information about these individuals, or if they are registered with these agencies. The division is also in contact with the SEC and other states by telephone, exchanging information on registrations and investigations.

In the past four fiscal years the division referred 25 cases to other regulatory agencies for determination. The division often works with the SEC in joint investigations of its own violation cases.

Division personnel attend "securities conferences" with other states and the SEC. According to the regional administrator of the SEC, these conferences provide a trade of information on security "schemes" and violations in fashion at the time, and an education in recent developments in regulation. During the last fiscal year, the division used 68 percent (\$1,612) of its travel budget to attend such conferences. In addition, the division reported using \$600

¹ Section 15-2024(1), R.C.M. 1947.

of Law Enforcement Assistance Administration (LEAA) funds for conference travel.

SUMMARY

Montana began regulating the sale of securities in 1913. The present securities law was passed in 1961 and is similar to "uniform" securities laws in 31 other states. Under the present law, regulation is accomplished by the Investment Division of the State Auditor's Office. The division is staffed by five individuals and is funded through General Fund appropriations. The division regulates through the registration of securities, broker-dealers, investment advisers, and salesmen. The division also enforces securities laws, collects fees, and maintains liaison with regulatory agencies in other states, Canadian provinces, and with the SEC.

Chapter III

THE RELATIONSHIP OF STATE REGULATION TO THE PUBLIC'S HEALTH, SAFETY, OR WELFARE

This chapter addresses two questions posed by the sunset law: Would the absence of regulation significantly harm or endanger the public's health, safety, or welfare? Is there a reasonable relationship between the exercise of the state's police power and the protection of the public's health, safety, or welfare? In defining the purpose of sunset legislation, Montana's sunset law (Section 82-4601, et seq., R.C.M. 1947) states that "The legislature questions whether conditions causing the establishment of these agencies, programs, and rules have not changed to such an extent as to remove the need for some or all of the agencies, programs, and rules." Accordingly, this chapter first reviews and analyzes the regulation of the sale of securities in Montana. The chapter discusses whether a public need continues to exist for this regulation. The chapter then discusses whether the current exercise of the state's police power, through regulation by the department, is reasonable.

FEDERAL REGULATION

Registration and regulation of the securities industry is divisible into two areas: (1) those areas of regulation that, by nature of the interstate and national characteristics of the securities, are assumed by the federal government, and (2) those intrastate activities over which the

federal government has declined jurisdiction. In the later case, regulation is left to the states which formulate their own laws called "blue sky" laws.

The basis for federal regulation is the various securities laws administered by the Security and Exchange Commission (SEC).

Securities Act of 1933

The Securities Act of 1933 has been referred to as a "truth in securities" law. The act has two basic objectives:

- To provide prospective investors with information concerning securities offered for public sale.
- To prohibit misrepresentation and other fraudulent practices and acts in the sale of securities.

The SEC requires that an issuer file a registration statement setting forth required information, before a security is offered for public sale. The object of the registration statement is to disclose facts containing relevant data upon which investors can evaluate the securities and make a judgment as to their investment merit.

In general, federal registration requires information on:

- The management of the registrant.
- The provisions of the security offered for sale and its relationship to the registrant's other capital securities.
- The registrant's properties and business.
- Recent certified financial statements of registrant.

Certain securities and transactions are exempt from the SEC registration requirements:

- Offerings restricted to the residents of the state where the issuer is organized and in business.
- Private offerings to a limited number of potential purchasers.
- Offerings not in excess of certain specified amounts (usually \$500,000).
- Securities of governmental instrumentalities.

The principal exemption under this act is Regulation A. It provides that offerings of securities in an amount under \$500,000 may be exempt. However, the fact that offerings are exempt does not remove them from SEC supervision. The SEC still requires the filing of an offering circular containing basic information, and a notification to the SEC regional office. Deficiencies in the circular and fraudulent conduct can bring about SEC action.

Registration with the SEC does not ensure the investor against financial loss. The only SEC requirement is the adequate "disclosure" of facts relative to the securities and the company offering those securities. The SEC may not bar the sale of securities on the grounds of fairness of price or other terms or the risk associated with the security. These factors with their related risk must be decided upon by the investor. The registration statement does not guarantee the accuracy of the prospectus or the offering circular. But, false or misleading statements can bring about sanctions in the form of fines and imprisonment. Investors suffering a loss may then recover damages if an

incomplete or inaccurate registration statement has been used. This liability extends to the issuing company, directors, underwriters, and to sellers of the securities.

Securities Exchange Act of 1934

This act extends the disclosure policy to securities listed on registered securities exchanges. Issuers must file a registration statement with both the exchange and the SEC. Periodic reports must also be issued to update the information originally filed. These reports are used by brokers, dealers, investment advisers, etc., as a source of information when advising clients. Investors may bring an action against an issuer if losses are suffered as a result of relying on false or misleading reports.

The Exchange Act contains certain provisions to prevent the misuse of corporate information not readily available to the general public by the officers and directors of a company who own over a certain percentage of the company's securities.

The Securities Exchange Act also provides a system to regulate trade practices in the exchanges and over-the-counter markets. The law attempts to prevent fraud, deceit, and market manipulation. The SEC has adopted regulations, which define prohibited practices, and provide for safeguards with respect to the financial responsibility of brokers and dealers in the over-the-counter market.

An important part of the act is the requirement for registration of brokers and dealers engaged in interstate

securities activity. Brokers and dealers must comply with the standards prescribed by law and with the regulations of the SEC, or risk the loss of the right to conduct an interstate securities business. The SEC can and does check for compliance through unannounced inspection of books and records of brokers and dealers.

It is the responsibility of the SEC to investigate complaints of alleged violations in securities transactions. Investigation and enforcement under the Securities Act of 1933 and the Securities Exchange Act of 1934 is the primary responsibility of the SEC regional offices. The SEC has the authority to issue subpoenas for sworn testimony and the production of records. The SEC also monitors market fluctuations which do not appear to be the result of known trends or market developments. When gathered evidence indicates that a violation has been committed, the SEC may pursue several avenues of remedy:

- Suspend trading on the market.
- Bring civil injunctions.
- Refer for criminal prosecution and possible indictment.
- Revoke privileges of registration.
- Expel members from exchanges and the over-the-counter market.
- Obtain ancillary relief (e.g., placing existing money in trust for reimbursement of stockholders).

The number and the types of SEC actions for fiscal 1967 through 1976 are as follows:

SEC Securities Actions

Fiscal* Year	Cease and Desist Type Orders	Criminal Actions	Injunctive Actions	Convictions
1967	267	104	25	127
1968	142	106	39	84
1969	169	104	49	83
1970	168	118	27	55
1971	255	142	11	89
1972	234	178	29	75
1973	206	204	61	83
1974	275	179	61	81
1975	293	174	75	116
1976	566	163	92	97

*Federal fiscal year

Source: Reports and Information Services of the SEC

Illustration 3-1

Public Utility Holding Act of 1939

The federal government determined that since the securities of public utility holding companies and their subsidiaries are widely marketed, and that public utility activities extending over many states are not susceptible to effective control by any one state, there is a need for federal regulation. Thus, the interests of investors and the interest of consumers of electricity and natural gas would be better served under a system of full disclosure. The act mandates that the companies disclose appropriate

information so investors can appraise the financial position or earning power of the company. The law has two primary purposes: (1) to curb abusive practices of public utility companies by bringing them under effective control, and (2) to provide effective regulation of the expanding business of transmitting and selling electric power in interstate commerce. Examinations of required information; investigations to determine violations; and formulation of rules, regulations, and orders are the functions of the SEC.

Trust Indenture Act of 1939

The Trust Indenture Act attempts to protect and enforce the rights and interests of investors in notes, bonds, debentures, evidences of indebtedness, and certificates of interest or participation in any of the preceding. This act, like other securities acts, is a full disclosure law. The act requires the filing with the SEC of a registration statement and prospectus to prevent fraud by fully and fairly disclosing the nature and finances of companies to the investors. The SEC has investigative and enforcement functions similar to its role in the other securities laws.

Investment Advisers Act of 1940

Similar in respects to the provisions of the Securities Exchange Act, the Investment Advisers Act requires that persons or companies who advise others as to the value of securities or as to the advisability of investing in, purchasing, or selling securities must register with the SEC and conduct activities in accordance with standards acceptable to the SEC.

The SEC may deny, revoke, or suspend registration. The commission may seek injunctive relief in the courts to prohibit violations, and the SEC may also refer matters to the Department of Justice for prosecution.

The act requires that an adviser disclose to clients any possible conflict of interest in transactions and that he maintain proper books and records. The SEC is authorized to conduct inspections of such books and records.

Investment Companies Act of 1940

Securities issued by investment companies constitute a substantial part of all securities offered. Because the activities of such companies extend over many states, it is difficult to have effective state regulation in the interest of investors. The act, therefore, was primarily aimed at the protection of individuals who purchase securities issued by an investment company. It provides for disclosure of pertinent facts to shareholders and requires fair management, investment of assets for the benefit of shareholders rather than of management, and sound financing of the company. The act formulates a comprehensive regulatory method to prevent certain abusive practices in the management of investment companies. The SEC is also responsible for the execution and administration of this act.

Securities Investor Protection Act of 1970

The Securities Investor Protection Act was enacted to provide some assurance to investors that they would not suffer financial loss as a consequence of bankruptcy or due

to other financial difficulties of their stockbrokers. The act provides protection for securities purchasers similar to that enjoyed by bank depositors under the Federal Deposit Insurance Corporation. The law is designed to facilitate the return of funds or property to customers of insolvent brokerage firms.

The act establishes an entity known as the "Securities Investor Protection Corporation" (SIPC). The members of SIPC are all persons registered as brokers or dealers under the Securities Exchange Act of 1934, and also all members of a national securities exchange. Fees from approximately 5,000 brokerage firms throughout the country create the SIPC fund, which currently has a balance of about \$150 million. The maximum reimbursement is set at \$100,000, with \$40,000 available to cover cash in a customer's account.

SIPC relies on NASD, the stock exchanges, and the SEC to advise when brokerage firms are in financial trouble. Since its creation, SIPC has presided over 129 brokerage firm liquidations nationwide with claims totalling \$229 million. SIPC has distributed \$203,272 in Montana liquidation actions since 1972.

Commodity Futures Trading Commission Act of 1974

The Commodity Futures Trading Commission was created by the Commodity Futures Trading Commission (CFTC) Act of 1974 to regulate the trading of "futures" (the sale of commodities for future delivery). The act does not supersede

or limit the jurisdiction of the SEC or other regulatory agencies dealing in securities other than "futures".

Generally, the CFTC oversees the registration of those individuals and associations involved in commodity futures trading, investment, and related advisory services. It is also authorized to supervise the contract markets (futures exchanges), make and promulgate rules and regulations, and investigate and discipline those parties registered with it.

SECURITIES INDUSTRY SELF-REGULATION

The Securities Exchange Act of 1934 provides that associations or exchanges will be basically self-regulatory, with the power and authority to discipline their own members. However, the act empowers the SEC, by order, rule, or regulation, to change or supplement the rules of the exchanges or association to accomplish the desired objectives of investor protection.

Stock Exchanges

The Securities Exchange Act requires that exchanges having a substantial trading volume register with the SEC. There are 15 exchanges registered under the act. The most common exchanges are the American Stock Exchange, Midwest Stock Exchange, New York Stock Exchange, and the Pacific Coast Stock Exchange. The exchanges do not buy or sell securities, but merely provide facilities for others to do so.

It is advantageous for brokers and commission houses to become members of the exchanges so they can act for buyers

and sellers. The exchanges adopt rules and regulations to ensure fair treatment and protection of investors. Provisions are set for disciplining members for misconduct, and periodic inspections of members' books and records are conducted to ensure compliance. Members can be suspended or banned from trading due to violations. For fiscal year 1976, the exchanges reported 81 actions taken against 117 respondents.

Corporations listing their securities with exchanges are required to issue statements showing their financial position and periodic reports of their earnings. The earnings statements are issued quarterly. The disclosure of the financial information is of help to investors.

National Association of Securities Dealers (NASD)

The NASD is organized to be an independent, self-regulatory corporation with By-laws, Rules of Fair Practice, and a Code of Procedure for Handling Trade Practice Complaints. Membership in NASD entitles a security firm to participate in over-the-counter securities business on a preferential basis, to distribute new issues which have been underwritten by NASD members, and to distribute shares of investment companies which are sponsored by NASD members.

Members must subscribe to standards of ethical conduct. The association has established qualification examinations as prerequisites for registration with NASD. The examination must be passed by new sole proprietary applicants for membership or for registration as representatives. An

examination must be taken by all sales personnel. Prior to examination, each applicant is investigated to determine that he has not violated any federal or state law or any rule of the NASD or stock exchanges. Membership in NASD is almost universal of those broker-dealers and salesmen operating in Montana. A random sample of salesmen registered by the Montana investment commissioner indicates that at least 93 percent hold NASD membership.

The enforcement of the association's By-Laws, Rules of Fair Practice, and policy interpretations rests primarily with District Business Conduct Committees. The District Business Conduct Committee of NASD, along with the district director, is responsible for: (1) reviewing all examination reports submitted by NASD examiners in its District; (2) investigating all complaints against members and persons associated with a member who appear to have violated the association's By-Laws and Rules of Fair Practice, (3) conducting disciplinary proceedings, and (4) rendering decisions and imposing penalties. In fiscal year 1976 NASD reported 144 actions taken against 227 respondents.

NASD has also formulated a self-liquidation program which acts as an early warning system in the case of financial difficulty of one of its members. Since 1974, this program helped 55 firms liquidate \$43 million. This is done in conjunction with periodic investigations of members' books and records.

The NASD prints a manual containing not only a list of all members and other vital information, but also a list of members expelled from the association, all registered representatives whose registrations have been revoked and all members and registered representatives who have been suspended. These periodic supplements are sent to all 50 states.

STATE REGULATION

Although the objectives of both state and federal securities regulation are the same, there is variability in practice and theory between the state and federal acts. The two principle types of security regulations are "disclosure" and "qualification." The first is exemplified by the federal laws and the second by the Montana securities act.

The "qualification" type securities law is designed to vest with the investment commissioner the duty and responsibility of determining whether a proposed issue of securities qualifies for the right to be offered to the public. In doing so, the merits of the offering, as well as full disclosure are considered.

As noted in Chapter II, Montana has adopted the Uniform Act in all four parts:

- The registration of broker-dealers, salesmen, and investment advisers.
- The registration of securities.
- The prohibition of fraudulent practices.
- General provisions concerning judicial review, investigation, and injunctive and criminal proceedings.

In adopting the Uniform Act, Montana adopted the same definition of a security as stated in federal law and many other state acts.

The constitutionality of the Montana act has not been questioned. A challenge to the constitutionality of a Florida law with the same regulatory functions as the Montana act determined that the law reflects a valid exercise of the police power of the state.¹

Registration of Broker-Dealers, Salesmen, Investment Advisers

It is unlawful for any person to transact business in Montana as a broker-dealer, investment adviser, or salesman unless he or she is registered under the Securities Act of Montana.² The qualifications for registration in the law are very general. Broker-dealers and investment advisers must only file an application in the form prescribed by the commissioner and pay the registration fee. The type of information required includes:

- Place and nature of business.
- States in which licensed or denied the right to practice.
- Consent to service of process.
- Officers, directors and partnerships; including their knowledge, training, and experience of the securities business.
- Current financial reports.

¹ McElfresh vs. State of Florida, 151 Fla. 140.

² Certain exemptions are noted in previous discussions.

--Adverse judgments, suspensions, or expulsions.

--References concerning their ability to conduct business.

--Organizational make-up of business.

The commissioner has adopted rules and regulations to govern the activities of broker-dealers. Each broker-dealer is required to establish and maintain current records of all purchases, sales, and deliveries of securities. The broker-dealer must also maintain current ledgers and memos of each brokerage, purchase, and sale order. Monthly trial balances are to be kept and quarterly and annual financial statements are to be filed with the commissioner.

All salesmen registering in Montana must be legal residents and must have actually resided in the state for a period of at least one year. However, the commissioner may waive the residency requirement for good cause, and has done so in the past. Persons employed by brokerage firms governed by the regulations of the SEC are also exempt from residency. Thus, only a small number of salesmen are required to be residents, and usually are because of the intrastate nature of the offering. Salesmen must also file proof of \$5,000 bonding with their application.

The investment commissioner requires the following information from salesman applicants:

--Physical description.

--Place and nature of business; types of securities to be sold.

--Other areas where individual is registered; i.e. stock exchanges, other states.

--Employment, educational, and residential history.

--Adverse orders or judgments, violation of securities laws.

--Consent to service of process.

--Issuer or broker-dealer appointment of salesmen.

The commissioner maintains discretionary authority over all registrations. He may, by order, deny, suspend, or revoke the registration of any broker-dealer, salesman, or investment adviser for any of the following reasons:

--The application is incomplete in any material respect.

--Conviction of any misdemeanor involving a security, or any felony.

--The applicant is the subject of an injunction.

--Dishonest or unethical practices in the securities business.

--Insolvency on the part of applicant.

--Lacks training, experience, or knowledge of the securities business.

--Failure to pay the registration fee.

The registration process is basically a clerical function handled by the secretarial staff. If all required information is listed and no derogatory information is received from the SEC or NASD, the applicant is registered.

Registration of Securities

It is unlawful for any person to offer to sell any security in this state, except securities and transactions exempt under the act, unless the security is registered by

notification, coordination, or qualification.¹ These three types of registration were discussed in Chapter II.

Disclosure of information is a basic part of the registration requirement. Under all types of registration of securities, the following kinds of information are sought:

- The location and organization of the issuer's business.
- Description and specimen of securities being sold.
- Amount offered in the state and the selling price.
- Plan of distribution and description of options.
- Copies of the offering circular or prospectus.
- Other states in which the offer is being made.
- Certified financial statements of the condition of the issuer.
- Amount of securities held by the officers and promoters of the issuer.
- Amounts of underwriting discounts and commissions.
- Consent to service of process.
- Any adverse judgments, orders, or decrees in connection with the offering.
- Proceeds (amount, use, and order of priority).

The commissioner may, by rule or otherwise, permit the omission of any item of information or document from any registration statement. He may require the filing of progress reports to keep reasonably current the information contained in the registration statements, and require that certified annual financial statements be filed with the

¹ Section 15-2013 and 15-2014, R.C.M. 1947.

division under the provisions of notification or qualification.

Any sales material used in connection with the sale of securities must first be approved by the investment commissioner. This approval nature of the Securities Act of Montana distinguishes it from federal regulation. Federal securities law is based on disclosure. The state law requires disclosure, but the commissioner may also deny an application if "The offering has worked or tended to work a fraud upon purchasers or would so operate. . . ."¹ He may deny registration for several other reasons.

Among the provisions that can be used for denying registration are:

- Excessive underwriting commissions and offering expenses.
- Cheap stock issued to promoters and corporate officers in return for organizational efforts.
- Inappropriate amount, kind, or holders of options or warrants.
- The issuer's enterprise or method of business includes or would include illegal activities.

State-imposed merit requirements, therefore, are a far more "protective" form of regulation than mere full disclosure of information.

The actual process of registering securities is performed by the examiners and secretarial staff. The examiners review pertinent material filed by the issuer during

¹ Section 15-2012(1)(e), R.C.M. 1947.

registration to determine whether a proposed offering has met all disclosure and merit requirements. In making their examinations, they may require additional information on an offering to obtain compliance and to clarify any reported statements. The final decision on allowing registration is made by the chief deputy, or the examiner in "routine" cases. As noted earlier, over 90 percent of all registrations with the investment commissioner are by coordination. Registration by qualification, which makes up almost entirely the remaining registrations, takes more of the examiner's time per examination. We noted that registrants by qualification were usually not as familiar with securities regulations and had to be "led" through compliance by the Investment Division through active correspondence.

Prohibition of Fraudulent Practices

By law, the commissioner, at his discretion, may make investigations or examinations within or outside the state to make a determination on any registration or to determine whether any person has violated or is about to violate any provision of the Securities Act or division rule.

Fraudulent and other prohibited practices are:

- Employing any device, scheme, or artifice to defraud.
- Making untrue or misleading statements of material fact, or omitting necessary facts.
- Engaging in any act, practice, or course of business which operates or would operate as a fraud.

The investigator/examiners and the deputy commissioner conduct investigations on-site and through use of the telephone. For fiscal year 1977-78, the division used approximately 30 percent of their travel budget (\$545.82) on investigations. This involved on-site inspections, obtaining affidavits, and issuing subpoenas.

Evidence gathered in the course of an investigation is compiled in a case file. The commissioner, when appropriate, refers such facts concerning the violations of the act to the attorney general or the appropriate county attorney, who may institute the appropriate criminal proceedings. Action to enjoin any prohibited acts or practices and to force compliance with the act may be brought by the commissioner in any court of competent jurisdiction.

Division officials have cooperated with the SEC, IRS, and other states in the investigation of securities related crimes. Officials also attend securities law enforcement conferences. The staff attorney has attended several of these conferences to become familiar with securities law and regulation. The attorney has also been used to aid in the preparation of cases for prosecution.

General Provisions on Judicial Review, Criminal and Civil Liabilities

The Securities Act states that any person dissatisfied by a final order of the commissioner may obtain a review of the order in any court of competent jurisdiction. A division official informed us that an administrative order has

seldom been issued, (only 7 in 10 years) and that review proceedings have not been held. According to the official, the action usually taken by the division is to allow withdrawal of a registration rather than undertake administrative proceedings.

Criminal liabilities under the act are specific. Conviction brings a fine of not more than \$5,000 or imprisonment not more than three years, or both. Prior conviction of a violation causes a mandatory sentence of at least one year. Civil liabilities are also delineated. An individual can sue to recover the money paid for the security, interest at 6 percent per annum from the date of payment, and attorney's fees. In its past ten year enforcement record, the division has been directly responsible for nine convictions and the recovery of over \$800,000. A more detailed description of the record is in Chapter II. (Illustration 2-10.)

WOULD THE ABSENCE OF REGULATION HARM

To view the securities industry in the absence of regulation, a summarization of the total regulatory structure, presented in the first part of this chapter, is required. The following chart provides a quick review of the type and extent of regulation.

STRUCTURE OF SECURITIES REGULATION

	Federal	Self-Regulating	State
Regulatory Laws	Securities Act of 1933 Securities Exchange Act of 1934 Trust Indenture Act Investment Advisers Act Investment Company Act Securities Investors Protection Act	Securities Exchange Act of 1934 By-Laws, Rules of Fair Practice	Securities Act of Montana Uniform Commercial Code
Type of Law	Full Disclosure Fraud Statutes	Compliance	Disclosure Fraud Statutes Merit Requirements
Regulatory Bodies	SEC SIPC	NASD Exchanges	Investment Division
Jurisdiction	Interstate sale of securities	Members	Securities offerings in Montana
Activities Regulatory	Registration of Securities Registration of Brokers, Dealers, Investment Advisers Investigation of complaints Periodic Audits and compliance checks Communication with other regulatory bodies	Listing of Securities Registration of Broker-Dealers and Representatives Investigation of complaints Periodic Audits and compliance checks Communication with other regulatory bodies	Registration and qualifying of securities Registration of Broker-Dealers, Investment Advisers, Salesmen Investigation of complaints Periodic Audits of broker-dealers and issuers Communication with other regulatory bodies

Source: Compiled by the Office of the Legislative Auditor.

Illustration 3-2

In the absence of regulation the only type of law regulating "interstate" securities would be a federal "disclosure" law. Any judgement as to the merit of offerings would not be required. In the past, merit requirements have been attacked academically as unnecessary restrictions on free enterprise and unwarranted limitations on promoters' profits. We asked the Investment Division to furnish specific information to illustrate that the denying of an offering, based on not meeting merit qualifications, saved money for the investing public. The division could not furnish the information and stated it would be difficult to determine the exact savings. We did, however, discover a Wisconsin study performed in 1971 which relates to this issue.¹ The study concludes that the data obtained from the review of registration rules similar to Montana's established a case for the importance of those registration standards in general, and that the merit requirements are effective in protecting the investing public.

Under deregulation, registration of broker-dealers, investment advisers, and salesmen would be performed by the SEC, for those who qualified under federal regulations. Those individuals who engage in only intrastate securities sales would be exempt. The information on applicants gathered under the present system of registration would be lost. Violators of SEC or NASD regulations could sell in

¹ Blue Sky Law: Is There Merit in the Merit Requirements? Wisconsin Law Review: 1976:79.

Montana since preventive measures, such as the check on derogatory information done by the Investment Division prior to state registration, would not exist. If these individuals became repeat violators, then the public would be harmed.

The commissioner has the authority to audit the books and records of broker-dealers. At the present time he does not perform this function since these same broker-dealers are audited by the SEC, the Exchanges, and NASD. To do so would be unnecessary repetition, since state standards are very similar to those of the other regulatory bodies. The absence of state regulation in this area would apply only to that rare situation where a broker-dealer is not regulated by any other body.

The absence of state regulation would also break down the informal communication system set up between all regulatory bodies. Montana would be less able to aid other states and the SEC in investigation and enforcement. The direct involvement of the Investment Division in the recovery of over \$800,000 may not have happened under deregulation. The stop-orders issued by the commissioner, and the convictions through criminal proceedings may not have occurred under the absence of regulation.

A review of the federal, state and self-regulation of the securities industry reveals a massive and far reaching regulatory structure. The objectives of state, federal, and self-regulation are the same, but they are accomplished

through different practices and theories. Totally removing state regulation creates a gap in the regulatory structure. Therefore, it may be concluded that the investor and the public in general would not be effectively protected, and the absence of state regulation of the securities industry would harm the public health, safety, or welfare.

EXERCISE OF THE STATE'S POLICE POWER

The next section of this chapter answers the question: Is there a reasonable relationship between the exercise of the state's police power and the protection of the public's health, safety, or welfare? As discussed earlier, there has been case law indicating the regulation of the securities industry by the states is a proper exercise of the state's police power. Therefore, the question is not whether the regulation of securities should be performed by the state, but rather what extent and degree of regulation is needed to adequately protect the public.

To answer this question, a review of the regulatory process is warranted. It was noted earlier that Montana adopted the Uniform Securities Act, which was formulated through a cooperative effort of federal, state, and industry organizations. The act was written to attempt to provide the states with a workable regulatory law. Montana adopted this "pattern state law" in all its parts. A discussion of each of these parts in relation to the exercise of the state's police will answer the overall question.

Registration of Securities

In connection with the registration of securities, the Montana act permits registration in three different forms. Having filed with the SEC, registration by coordination avoids the time, effort, and expense incident to furnishing substantially the same information, in compliance with both state and federal requirements. It was noted that approximately 91 percent of all securities' registration in Montana is by coordination.

Registration by notification is also a selective type registration, but is not widely used in Montana. All non-exempt offerings not eligible for registration by the other two procedures must be registered by qualification. Approximately 8 percent of the registrations in Montana are by this method. Disclosure requirements are similar to that of the coordination method. Preparation of financial statements is not intended to be burdensome, since no audited financial statements are necessary. The division has actively checked for disclosure compliance under this type of registration. Issuers who have registered by qualification were contacted and related that the division had been helpful in the registration process. Exempt securities, such as those listed with the major stock exchanges, are not subject to overlapping regulation since the exchanges regulate their own members.

We conducted a compliance test of the securities registration requirements of the investment commissioner. This

check was performed to determine if all disclosure information required by law and regulation was on file. In only one case did we find information missing. An issuer who had renewed did not have on file a recent prospectus or annual financial report. We noted also that all companies who file articles of incorporation with the Secretary of State receive a letter notifying them that it may be necessary to register with the investment commissioner. In this way, an attempt is being made to limit the possible sale of non-registered securities.

State-imposed merit requirements on securities registration have often been questioned as an inappropriate function of state government. There are those who believe that this type of regulation may result in harmful economic consequences because it has a retarding effect on the creation and growth of new enterprises. Advocates of the merit approach contend the prospectus is too long and too complex to be meaningful to the average investor. They also contend that the success of certain ventures is just too speculative to warrant public participation. Lawyers and economists have discussed this merit issue, but there appears to be only one empirical study which analyzes the effect of such regulation. This study, referred to earlier in this chapter, concluded that such rules have proved effective in protecting investors' interests. The results of this "lone" study conclude that the state merit requirements protect investors, in that the gains of protection outweigh the

possible economic gains of the "nonmerit" securities. Thus, the registration of securities at the state level is designed to compliment the federal registration requirements, and the division exercises its authority under the law through examination of registrant files and ruling on the merits of an offering.

Registration of Broker-dealers, Investment Advisers,

Salesmen

This particular area of regulation is performed by federal, state, and industry entities. The registration requirements of the Montana act apply to "any person" offering to sell any security in the state unless an exemption is available. The provisions of the Montana law specify only that the application for any registration contain whatever information the commissioner requires. Information is the key word. At the present there are no specific experience, educational, or examination requirements connected with the Montana Securities Act. The commissioner, however, may deny a registration if, in his discretion, the applicant lacks training or knowledge of the securities business. The NASD, SEC, and the stock exchanges have examination requirements. Since a large majority of salesmen in Montana have taken these examinations (97 percent), there appears to be no need for additional testing. The investment commissioner has however, requested the formulation of a test on Montana Securities Law for all those persons registered.

The full disclosure of facts is the basis for this area of registration. Information on the types of securities being sold, the organization of the issuer, and the background of the registrant are filed for reference and used to determine derogatory information. Uniform forms used by other regulatory agencies are used for efficiency.

Random samples of broker-dealers, investment advisers, and salesmen files were examined to determine if registration and renewal requirements were in compliance with state law and are being enforced:

--A random sample of 161 of the 1,087 salesmen files revealed very complete records. Only four late renewals were discovered.

--A sample of 57 of the 138 broker-dealer files found the files generally in order. Three files were missing information (two had outdated financial statements and one contained no service of process form). This information was subsequently requested of the broker-dealers.

--All eleven investment adviser files were reviewed and all information was in order and complete.

It appears the division is enforcing the disclosure requirements of registration. In the course of the review, we also were able to verify that the NASD and the SEC are contacted to determine if any derogatory information on the registrants was on file with these bodies. An attempt was made by the division to also routinely contact other states for derogatory information, but the slowness of response seriously delayed the registration process. This check is no longer performed.

After salesmen (registered or unregistered) have been involved in an investigation where they participated in securities-related crimes, the division creates a classification of information on them. If the individual was registered in Montana, his file will be "flagged" so that registration cannot be completed at a later date. If the salesman was unregistered in Montana he is added to an investigator's card file with reference to the investigation file. This card file is not routinely reviewed by the division official registering the salesmen. To determine if this is an area for concern we reviewed the investigation files of the division to find those salesmen previously investigated. A sample of 87 salesmen was checked against presently registered salesmen to verify that no violator was registered. We found no problem with the registration of former violators. However, there appears to be two weaknesses in the process. First, not all individuals investigated have been added to the card file, or put in a flag file. We tested 39 investigated salesmen and found four (4) cases where the salesman had neither a flagged file nor appeared in the card file. In those four situations, it is likely the individuals were on file with the SEC and thus no breach of the registration process occurred. The omissions appear to be arbitrary since other SEC violators are on file. Second, unregistered violators are not added to the flagged file, but are recorded in the card file. (This was the case for 23 of 39 files reviewed.) As noted earlier,

there is no routine check of the card file by the official registering the salesmen. There is a possibility that an individual appearing in the card file, but not in the flagged file, could become registered. A check of the card file prior to registration would eliminate the weakness.

The current exercise of the state's police power, therefore, appears to be reasonably related to the protection of the public in the area of registration of broker-dealers, investment advisers, and salesmen.

Prohibition Of Fraudulent Practices

Prohibition of fraudulent and other prohibited practices can be viewed in relation to two functions of the state's police power. The first is to prevent fraud before it happens. This relates to the areas of registration previously discussed. The division requires and enforces full disclosure. It reviews the merits of a proposed offering, and investigates the backgrounds of offerings, broker-dealers, investment advisers, and salesmen.

The second area is the detection and elimination of fraud and prohibited practices. A review of the enforcement record of the division in recent years reveals that it has been active. A review of travel records for the division revealed on-site investigations for twelve different cases in fiscal year 1977-78. There have been 218 investigations conducted since 1972 for an average of approximately 29 investigations per calendar year. These are not all on-site investigations; many are simply data gathering by phone and

correspondence. A representative of the SEC stated that Montana is one of the more vigorous states in the area of enforcement. The division has also cooperated with the SEC and other states in joint investigations, and has referred entire cases to these other regulatory agencies. A 26-state survey of enforcement ranked Montana tenth in number of criminal charges filed, criminal prosecutions and convictions, even though it was 23rd in population size.

It was noted earlier that the commissioner has not held an administrative hearing and has issued no administrative orders revoking, suspending, or denying registration. The policy of the commissioner has been to allow the entity to withdraw its registration without prejudice. This action effectively halts all sales activity and has the same effect as an administrative order or injunction without requiring the full proceedings.

Investigation of complaints and activities connected with a registration are performed by the division. No other state agency investigates frauds and prohibited practices related to securities. Because the division cooperates and communicates with other regulatory bodies and has properly exercised its investigative function to recover funds for investors of the state, there exists a reasonable relationship between the exercise of the state's police power in prohibiting fraudulent acts and the protection of the public.

SUMMARY

The designing of the state securities regulatory law through the cooperative effort of federal, industry, and state regulatory entities is the major reason for a state act which is complementary of federal regulation. The exercise of the state's police power authorized in the Securities Act of Montana was previously discussed in three parts. In each case, the functions of the division were related to the protection of the public. In each case there appeared to be a reasonable relationship between the exercise of that particular state police power and the protection of the public.



Chapter IV

THE REGULATORY PROCESS

This chapter addresses a third question posed by the sunset law: Are all facets of the regulatory process designed solely for the purpose of, and have as their primary effect, the protection of the public?

DEPARTMENTAL STAFFING

The staffing of an Investment Division directly influences the regulatory ability of the division. The administrative staff of the division plays an integral role in the administration of state laws and must have the ability to oppose the best talent the securities industry can hire in disputes on securities, offerings, trade practices, and financial activities.

The Montana Investment Division uses an on-the-job training program for its employees. It does not have an operations manual for the investigators. In the regulation of an industry as ever-changing as the securities industry, it is difficult to imagine a staff's ability to "keep up" without the existence of some type of more formal training program and operations manual.

As noted, the attorney for the Auditor's Office reported devoting about 30 percent of his time to the Investment Division. The attorney's duties include responsibilities to the Insurance Department of the State Auditor's Office, and to the State Auditor's Office in general.

To keep up with the enormous amount of federal and state regulatory requirements for insurance and securities, the attorney would have to spend a considerable amount of time. The following are a few areas where an attorney could have been involved in securities regulation, but was not due to time constraints:

--Interpretation of the securities laws.

--Compiling evidence and formulating a case to present to county attorneys for prosecution.

--Prosecute cases for the Attorney General or County Attorney.

In the previous chapter the determination of the merit requirements of an offering was noted as a reasonable exercise of the police power of the state. In determining the proper qualifications of an offering, the division generally uses the provisions of the Securities Act, and the NASAA (North America Securities Administrators Association) and Midwest Guidelines. The main purposes behind these criteria are the protection of the investor and the proper flow of capital.

However, division officials must interpret certain areas of the securities act in order to protect the public. Without the constant availability of legal counsel, division officials have been forced to interpret the law without a legal opinion. In one situation the division required that investors in a highly speculative offering have a minimum amount of assets before they could participate in the offering. In this case the division is not ruling on the

merits of the offering, but is setting down suitability standards for investors, which we believe may not be within its authority under the Securities Act. A division official stated that suitability standards fall squarely within the merit requirements, and that in those areas where they are imposed, it is necessary to prevent the offering from being offered to a person who would be unable to benefit from the investment. Thus, a review of this authority should be undertaken by the division.

In conversations with those individuals regulated by the investment commissioner, there were some comments expressed relating to other interpretations of the act by the division as they relate to tax exempt, isolated, and private offerings. Their comments centered more on uniformity in interpretation rather than consequences of the ruling. These people believed that a division staff attorney familiar with securities would aid in clarification of certain aspects of the law.

PAYMENT OF REGISTRATION EXAMINATION EXPENSES

The Securities Act of Montana creates in the state treasury a fund known as the "investment department examinations revolving fund." This fund is to be used only for the payment of travel, living expenses, and per diem incurred by any duly authorized agent of the commissioner in the making of an examination connected with a registration under this act.¹ Any issuer or broker-dealer who is

¹ Section 15-2024(2), R.C.M. 1947.

investigated or examined in connection with a registration is to reimburse the commissioner, and the commissioner is to pay to the State Treasurer to the credit of the fund all money received.

The Investment Division has never been reimbursed for expenses incurred in an examination or investigation. It appears that the division should seek reimbursement for examinations and investigations as provided by law. If the division is uncertain as to its authority it should obtain an Attorney General's opinion or legislative clarification.

INVESTIGATION FILES

Proper management of all facets of the investigation process can only lead to more effective protection of the public. Included in this proper management should be files maintenance.

The investigation files in the Investment Division have no standard format or uniform contents and thus often have little meaning to anyone other than the Investment Division investigator involved with the particular case. Files contain such items as correspondence regarding the case, transcripts from any court proceedings, and evidence such as cancelled checks and security specimens. However, one cannot be sure to find any of these items in any one file. Furthermore, it is usually very difficult, or at least tedious, to reconstruct the case using file documents and investigator's notes, which are for the most part meaningful only to someone already familiar with the case. The more

recent files do show an attempt to upgrade and improve reporting.

In the process of reviewing the closed investigation files, a sample of size 34 was chosen from a numbered list of files. At the time of the review, the files were numbered 1 through 93, plus an additional file numbered 102. File number 51 is subdivided into other files (numbered 51-1 through 51-124) which contain information on inquiries or short investigations. In total, there were 218 numbered files. Of the 34 file numbers chosen, files could not be located which corresponded to 10 of the numbers chosen. There was no indication of what happened to these files. Division officials believed these files may have been turned over to other regulatory entities such as the SEC, the county attorneys, and the Attorney General, or are incorporated in other files since eight of the ten were "51" files.

Conversations with officials of the SEC noted that SEC investigative files are organized through the use of narrative descriptions of the progress of the case and standard forms summarizing the steps of the investigation. This type of procedure could increase the efficiency within the division and aid in determining and quantifying enforcement activity.

BONDING REQUIREMENT

Salesmen are the only individuals or entities registered who must file with the commissioner a bond of a surety

company duly authorized to transact business in Montana. The bond is in the sum of \$5,000 and payable to the state. The law provides that upon failure to comply with the act the salesman is liable to any persons suffering a loss. In this manner, the public is to be protected.

Although bonds are generally considered to be protection for the public and are required by the legislature for that purpose, certain aspects of the present form of bonding suggests it may be ineffective:

--The public must secure a judgment against the state before the bond will be surrendered, and the judgment cost may be greater than the grievence in some cases.

--The amount of the bond is too small in most cases to cover the probable losses a salesman could inflict; Montana's \$5,000 bond is the smallest of those western states with bonding requirements (in most cases the amount is \$25,000; and one state requires only a certain net capital by the registrant).

--The fact that no bond has ever been used to pay a judgment may be an indication that present bonding fails to be a source of public protection.

Since bonding is a prerequisite to registration we contacted several salesmen in Montana who are employed by resident issuers or broker-dealers to determine their views on the bonding requirement. In many instances we found that the bonds were very difficult to obtain in that the bonding companies were reluctant to write the bonds. On one occasion an individual terminated an attempt to obtain registration because of the amount of time and effort necessary to obtain bonding. The division's view on present bonding requirements is that an alternative type of bonding would possibly be more suitable, but that bonding requirements, in

general, are effective to the extent that bonds carry a "police effect," deterring violations under the threat of losing further bonding and employment.

SALE OF MUTUAL FUNDS

Mutual funds are considered securities; therefore, mutual funds must be registered with the investment commissioner. We reviewed the division files and in fact such funds are, and have been, registered with the commissioner.

In order to determine the extent of mutual fund sales, we made personal contact with those individuals who would most likely be selling such securities. During the course of our review we determined that non-registered persons have been selling what appear to be mutual funds, and we were given the prospectuses of the mutual funds which were sold.

We informed the officials of the Investment Division that individuals were offering for sale and handing out prospectuses of what appeared to be mutual funds, yet these individuals were not registered. Following a telephone contact with the companies offering the funds, a division official replied that in fact these individuals were not selling mutual funds, but variable annuities; and that the prospectus for the mutual funds were for informational purposes only.

Our contact with those individuals selling these funds gave us the strong impression these people believed they were selling mutual funds. One individual even referred to a previous sale of mutual fund. It appears there may be a

problem with salesmen's knowledge of the difference between mutual funds and variable annuities and their relating of this information to the public buyer. The department, therefore, should evaluate the sale of mutual funds to determine if additional enforcement and/or educational activity is necessary to assure that salesmen are adequately informing the public about the product being sold.

SUMMARY

This chapter has addressed the question of whether or not all facets of the regulatory process are designed to protect the public. Our review disclosed that certain improvements in the regulatory process would aid in further protecting the public. These improvements include: initiating a more formal training program, obtain additional legal services, clarification of the requirement of examination expenses to be paid by those investigated as required by law, maintaining files in a more efficient manner and controlling file release, evaluating the need for the bonding requirement, reevaluating the suitability standard requirement, and reviewing mutual fund sales.

Chapter V

COST CONSIDERATIONS

This chapter addresses the fourth and fifth questions posed in the sunset law: Does regulation have the effect of directly or indirectly increasing the cost of goods or services? Is the increase in cost more harmful to the public than the harm which could result from the absence of regulation?

REGULATION COSTS

What are the costs of regulation earlier mentioned? Costs of regulation are included in the monetary amount paid for goods or services, as well as the actual cost to administer the regulatory program. Regulation costs also include nonmonetary items such as the delivery and timeliness of goods or services--even the availability or absence of goods or services.

Costs associated with the administration of the regulatory program are quantifiable. We observed in Chapter II that the division must expend funds to administer the various security laws, rules, and regulations. While these costs exist, they represent only a minimal increase in cost to the public for investments and investment services.

Regarding the delivery of securities and related services, overly restrictive regulation could effect the supply of investments or investment services. Limiting supply could conceivably increase costs to the public. During the

course of this audit, we could find no evidence to indicate supply is overly restricted due to regulation.

As noted in Chapters II and III, issuers, broker-dealers, advisers, and salesmen must spend considerable time and expense complying with the various federal and state laws. Expenditures to comply with these laws are also ultimately passed on to the consumer. We also noted in Chapter III that Montana laws are designed to complement federal laws. Registration requirements have been streamlined to facilitate state registration when federal registration has already been approved. In addition, the use of uniform state forms and procedures further reduces the time and expense incurred when complying with state law.

It would be difficult to quantify the actual increase in cost due to state regulation. However, we can conclude that state regulation causes an increase in costs to the public; yet, this increase is probably minimal.

EFFECTS OF DEREGULATION

If regulation increases costs to the consumer, the important question becomes: Is the increase in costs more harmful than the harm which could result in the absence of regulation?

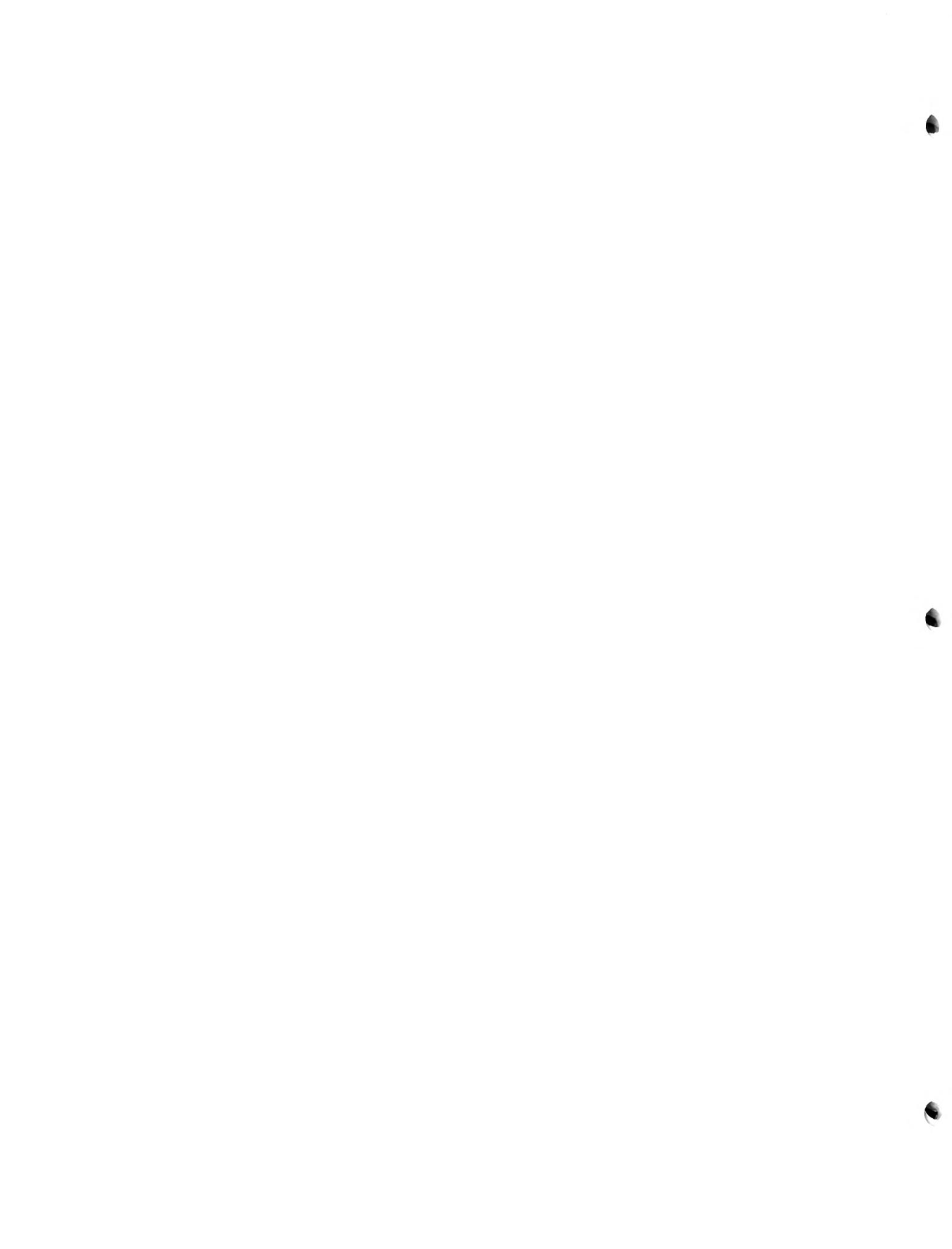
We concluded in Chapter III that the absence of regulation would harm the public. Without state regulation, issuers, broker-dealers, investment advisers, and salesmen would not be subject to state laws requiring registration. Individuals could be convicted for securities fraud in other

states and then come to Montana and sell securities. Securities issues sold only in Montana would be subject to no regulation whatsoever.

Another significant effect of deregulation would be the loss of the ability to investigate complaints on behalf of the Montana consumer. We earlier noted that, as a direct result of the Investment Division's activities, Montana consumers have been returned funds which otherwise may not have been returned.

Probably one of the most significant aspects of the present regulatory system is the pre-screening of individuals and companies who sell securities. We have evidence to show that certain investments have been withdrawn from sale due to direct division involvement. Without this regulation, the Montana investor might purchase a security that would otherwise be disapproved.

All states presently regulate the sales of securities. Many do so in a manner similar to Montana. Since there is no unregulated market, it is impossible to quantify the cost to the consumer if the securities industry were deregulated. Certainly one fraud or investment scheme which harms the Montana consumer could cost millions of dollars. Based upon this fact alone, we can conclude that the absence of regulation would harm the consumer. We can also project that the eventual costs associated with deregulation would be far in excess of the present costs of regulation.



Chapter VI

LESS RESTRICTIVE REGULATION ALTERNATIVES

A sixth and final question posed by the sunset law requires the evaluation of alternative forms of regulation. Specifically it asks: Is there another less restrictive method of regulation available which could adequately protect the public?

ALTERNATIVE REGULATION APPROACHES

In determining the appropriate regulation of the investment and securities industry there are three major decisions which must be made. These decisions relate to: (1) the proper form of regulation, (2) the regulatory entity that is required under a particular form, and (3) the type and extent of regulatory requirements placed upon the industry in each case.

Following is a brief discussion of the three major decisions. The decision process is then summarized in check-list format. A more detailed discussion of alternative regulation approaches has been prepared as a supplement to this and other sunset audit reports.¹

THE PROPER FORM OF REGULATION

In relation to the first decision, there are a number of alternative forms of regulation ranging from the most

¹ "Alternative Methods of Regulating Professions, Occupations, and Industries"--A Supplement to the Sunset Performance Audits," Office of the Legislative Auditor, 1978.

extreme form--licensing similar to the present system--to the least extreme--no licensing or regulation whatsoever. Following is a discussion of seven forms of regulation. They are licensing, practice restriction, reserve of title, limited statutory regulation, registration, certification, and no regulation.

Licensing involves the stipulation of requirements and prerequisites and the granting of the right or permission to carry on a business or profession. Licensing necessitates an administrative body that establishes rules and monitors the profession or occupation on an ongoing basis. Licensing is considered to be the most extreme form of regulation.

Restriction of practice is the next lesser form of regulation. Under a practice law form of regulation, individuals or companies would not be permitted to perform a specific service or act, or hold themselves out as being able to perform such services, unless they have met certain statutory requirements.

Reserve of title is less restrictive than restriction of practice. Under reserve of title regulation, anyone who desires could engage in the profession or occupation. Only the titles "licensed" or "certified," etc., would be reserved for those who had met certain requirements such as an examination.

Limited statutory regulation can be considered even a lesser degree of state regulation than the previous forms. The state would regulate the industry only through statutes

specifying certain limitations. Limited statutory regulation differs from a practice law in that there are no statutory requirements that are "job or ability related" (i.e., examination requirement). The law would require only "after-the-fact" protective measures (i.e., bonding and insurance).

Registration, the next alternative, would afford the opportunity to persons practicing in the profession or industry to register with the state or with a private trade or professional association. An individual or company applicant would not have to demonstrate competency or prove qualification, but would just register his name or the company's name.

Certification, as we define it, is individual oriented and requires no direct involvement by a state governmental body. The investment and securities industry would be responsible for certification requirements and procedures, and would be self-regulating. Certification would provide for public identification of those individuals designated by the industry as certified, but the industry could not limit practice in the industry to only those certified.

The least extreme form of regulation is no regulation. The public would still have protection and recourse through the Consumer Affairs Division of the Department of Business Regulation under the Unfair Trade Practices Act (Chapter 275, Laws of Montana, 1973), which protects the consumer from fraud and deception. Criminal and civil remedies can

also be sought under the Uniform Commercial Code and other laws directed at specific abuses. It is important to again note that the laws on consumer protection are in effect at the present time and would be in effect under all of the alternatives discussed.

THE REGULATORY ENTITY

Regulatory entities can take many forms depending upon the degree of state regulation needed. We have identified six regulatory entities: professional state board, professional-public state board, public state board, state department/agency, professional association, and state/local agency (indirect involvement).

The traditional form of regulation of most professions and industries is accomplished by professional boards. These boards are made up entirely of members of the profession or industry. Boards can also be made up of a combination of members from the profession and of members from the public. A board could also consist entirely of members from the public.

Regulation could be accomplished through the direct involvement of a state department or agency. If no direct regulation by the state is necessary, then a professional association could regulate its membership. In addition, indirect involvement by a state agency is available if direct state regulation is not necessary. For example, the Consumer Affairs Division could investigate and resolve

consumer complaints against any industry or occupation even if that industry or occupation were not directly regulated by the state.

TYPES OF REGULATORY REQUIREMENTS

If some form of regulation is determined to be appropriate for the investment and securities industry, then certain requirements and conditions for licensure must also be established.

Education, experience, and examination requirements, as conditions for licensure, could be established by statute and administered by the regulatory body. Means of financial protection for the public and licensees could be required in the form of bonding, recovery funds, errors and omissions insurance, etc.

The regulatory body, through its administrative branch, may collect fees such as those for examinations and licenses, and issue a document to companies and to individuals (license) following successful compliance with such prerequisites. The regulating body could have the authority to promulgate rules and adopt codes of conduct. It could deny, suspend, or revoke licenses based upon noncompliance, violations, or incompetence. The regulatory body could also have investigative and monitoring functions.

Periodic renewal of licenses could be a requirement. This renewal can be a mere payment of a fee, or renewal could depend upon the applicant meeting certain qualification standards. Thus, licensees could be required to

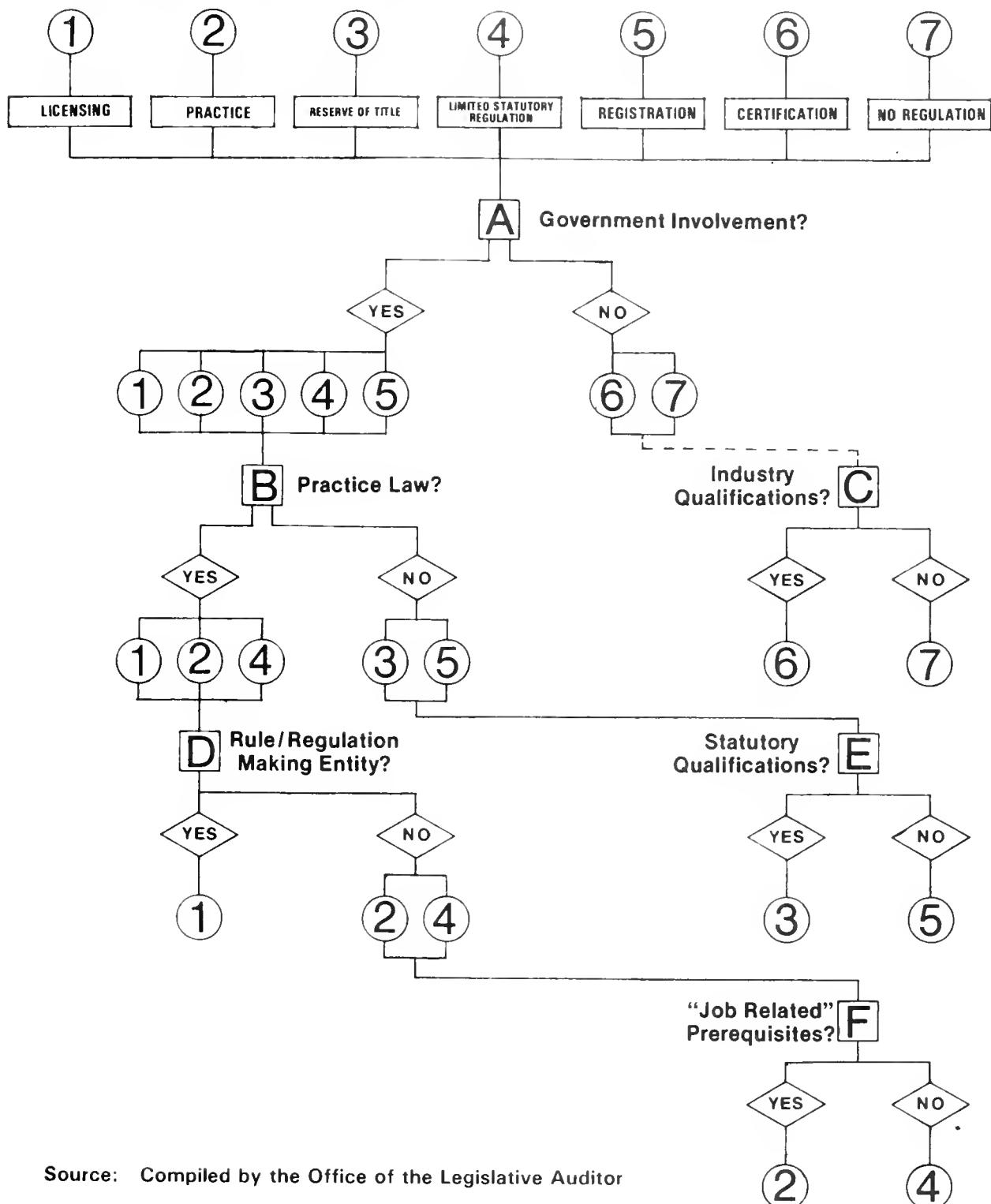
maintain proficiency through continuing education, passage of a periodic examination, or peer review.

SUMMARY

The decision as to the extent to which the state needs to be involved in regulation of a profession or industry requires the analysis of many factors. We have briefly discussed these factors in this chapter.

These factors are presented in decision chart format in the following Illustrations 6-1, 6-2, and 6-3. A more detailed discussion of the alternative methods of regulation appears in a supplement to this report.

DECISION CHART TO DETERMINE THE FORM OF REGULATION



Source: Compiled by the Office of the Legislative Auditor

Illustration 6-1

ALTERNATIVE REGULATORY BODY UNDER EACH FORM OF REGULATION

	LICENSING	PRACTICE	RESERVE OF TITLE	LIMITED STATUTORY REGULATION	REGISTRATION	CERTIFICATION	NO REGULATION
PROFESSIONAL STATE BOARD ► Multi-member; or ► Commissioner	<input type="radio"/>						
PROFESSIONAL-PUBLIC STATE BOARD ► Multi-member	<input type="radio"/>						
PUBLIC STATE BOARD ► Multi-member; or ► Commissioner	<input type="radio"/>						
STATE DEPARTMENT/AGENCY ► Direct involvement	<input checked="" type="checkbox"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>		
PROFESSIONAL ASSOCIATION ► Industry involvement					<input type="radio"/>	<input type="radio"/>	
STATE/LOCAL AGENCY ► Indirect involvement ► Civil/Criminal Sanctions	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

■ Indicates present form of regulation

Source: Compiled by the Office of the Legislative Auditor

Illustration 6-2

ALTERNATIVE REQUIREMENTS UNDER EACH FORM OF REGULATION

	LICENSING	PRACTICE	RESERVE OF TITLE	LIMITED STATUTORY REGULATION	REGISTRATION	*CERTIFICATION	NO REGULATION	PRESENT FORM
1. Rule/Regulation Making Entity	●							●
2. Educational Requirements	●	●	●			●		
3. Experience Requirements	●	●	●			●		
4. Examination	●	●	●			●		
5. Right of Denial	●	●	●	●		●		
6. Revocation/Suspension	●					●		
7. Issuance of a Document	●				●	●		
8. Investigation/Enforcement	●					●		
9. Periodic Renewal	●				●	●		
10. Continuing Education	●					●		
11. Retesting	●					●		
12. Reciprocity/Comity	●	●	●	●	●	●		
13. Bonding	●	●	●	●		●		
14. Recovery Fund	●					●		
15. Errors and Omissions Insurance	●	●	●	●		●		
16. Fees	●	●	●		●	●		
17. Individual Oriented	●	●	●	●	●	●	●	
18. Facility Oriented	●		●	●	●		●	
19. Peer Review	●	●	●			●		

* Determined by industry body

Source: Compiled by the Office of the Legislative Auditor

